*United States Court of Appeals*

*for the Second Circuit*

# BRIEF FOR APPELLEE

# 76-7528

*To be argued by*
W. FOSTER WOLLEN

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# United States Court of Appeals

FOR THE SECOND CIRCUIT

No. 76-7528

UNITED STATES STEEL AND CARNEGIE PENSION FUND, INC., CONNECTICUT MUTUAL LIFE INSURANCE COMPANY, and THE NATIONAL BANK OF COMMERCE OF DALLAS (as Trustee of the Omega-Alpha, Inc. Pool Trust),

*Plaintiffs-Appellants,*

—*against*—

HENRY OBENSTEIN, FIRST NATIONAL CITY BANK, HAYDEN STONE INC., BERNSTEIN-MACAULEY, INC., ROGER S. BERLIND, and SANFORD I. WEILL,

*Defendants,*

—*and*—

FIRST NATIONAL CITY BANK,

*Defendant-Appellee.*

*On Appeal from the United States District Court For the Southern District of New York*

## BRIEF OF DEFENDANT-APPELLEE

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## STATUTES AND RULES

I. Securities Act of 1933:

Sections 15—15 U.S.C. § 77o: Liability of controlling persons

Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under sections 77k or 77l of this title, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

Section 17(a)—15 U.S.C. § 77q(a): Fraudulent interstate transactions

(a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

II. Securities Exchange Act of 1934:

Section 10(b)—15 U.S.C. § 78j(b): Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5 promulgated under Section 10(b)—17 C.F.R. § 240.10b-5: Employment of manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

Section 20(a)—15 U.S.C. § 78t(a): Liabilities of controlling persons

(a) Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

# United States Court of Appeals

FOR THE SECOND CIRCUIT

Docket No. 76-7528

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UNITED STATES STEEL AND CARNEGIE PENSION FUND, INC., CONNECTICUT MUTUAL LIFE INSURANCE COMPANY, and THE NATIONAL BANK OF COMMERCE OF DALLAS (as Trustee of the Omega-Alpha, Inc. Pool Trust),

*Plaintiffs-Appellants,*

*—against—*

HENRY ORENSTEIN, FIRST NATIONAL CITY BANK, HAYDEN STONE INC., BERNSTEIN-MACAULEY, INC., ROGER S. BERLIND, and SANFORD I. WEILL,

*Defendants,*

*—and—*

FIRST NATIONAL CITY BANK,

*Defendant-Appellee.*

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*On Appeal from the United States District Court For the Southern District of New York*

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## BRIEF OF DEFENDANT-APPELLEE

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This brief is submitted on behalf of defendant-appellee Citibank, N.A. ("Citibank") (formerly known as First National City Bank), in response to the brief filed by plaintiffs-appellants United States Steel and Carnegie Pension Fund, Inc. ("Pension Fund"), Connecticut Mutual Life Insurance Company ("Connecticut Mutual"), and The National Bank of Commerce of Dallas (as Trustee of Omega-Alpha Inc. Pool Trust) ("Dallas Bank").

The decision below was rendered after a three week trial before the Honorable Whitman Knapp.* Immediately after conclusion of that trial (except for the testimony of one witness called as a court witness some weeks later), Judge Knapp announced a tentative decision in favor of Citibank and made preliminary factual findings and conclusions with respect to the credibility of witnesses. (A1524-A1538)**

Thereafter, the Court rendered its written opinion and stated that, "having reviewed the exhaustive briefs and the thoroughly documented findings of fact submitted by the parties, we see no reason to change our conclusion." (A22) The Court specifically adhered to its prior "findings and observations" pertaining to the facts and the credibility of witnesses, and therefore confined its opinion "to a broad outline of the relevant evidence." (A23, n.4 cont'd)

## PRELIMINARY STATEMENT

In 1965 Citibank acquired a factoring company called Hubshman Factors Corporation, which continued to operate as a factoring business in the same manner as a division of Citibank. The Topper Corporation ("Topper") account, first acquired in late 1966, was more than fully secured by Topper's accounts receivable and other assets. Citibank had no other relationship with Topper. (Fdgs D1, D7, D47) ***

The plaintiffs are extremely sophisticated financial institutions which purchased convertible subordinated debentures of Topper in September 1971 after a lengthy, if not terribly perceptive, investigation. They had extensive and

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* All other defendants, including Topper's president and its investment banker, Hayden Stone, Inc., settled before trial. One plaintiff, whose case was consolidated with this case for trial, did not appeal.

** Page references prefixed "A" are to the Joint Appendix on appeal.

*** The Findings of Fact of Citibank adopted by the District Court are denominated as "Fdg D"; those of plaintiffs are denominated as "Fdg P." They appear at pages A41-A348 of the Joint Appendix.

frequent contacts with Topper management and Hayden Stone, Inc. ("Hayden Stone"), Topper's investment banker and its agent for the September 28, 1971 private placement ("Private Placement") at issue here.

Plaintiffs' brief is remarkable in the detail with which it describes the Topper-Citibank relationship. It is equally remarkable in how conveniently it minimizes plaintiffs' contacts with Topper, Hayden Stone and others familiar with Topper's business. Finally, plaintiffs' brief is most remarkable in its manifold attempts to highlight, expand and dignify the one and only contact between plaintiffs and Citibank, a telephone call which the Court below found to have been of no more than five minutes' duration. (Fdg D233)

Judge Knapp decided that Citibank "was not directly involved" in the Private Placement pursuant to which plaintiffs invested in Topper. (A21) Additionally, the Court below found that Citibank continued to make advances to Topper after the Private Placement and did not begin to discover until three months later that Topper's accounts receivable were not as they were represented to be. (A24)

Shortly before the Private Placement, Henry Thompson, the investment manager of one plaintiff, had a five minute telephone conversation with Edward Waldman, the head of Citibank's factoring operations. The Court found that "nothing of any consequence was said in the course of the conversation which is not reflected in . . . the contemporaneous report that Thompson made to his superior, Molé." (A26, n. 7). This memorandum (A3532), which is quoted below (pp. 27-28, fn.) in full concludes by stating that Waldman declined to answer Thompson's question whether Topper was a good investment.

Thompson later prepared a decision memorandum on the basis of which the Pension Fund decided to invest in Topper. This detailed memorandum did not even mention Citibank, but made passing reference to the fact that

"retail trade and banking checks have been favorable." (A27)* The District Court decided that the Pension Fund did not seek investment advice from Citibank but rather that, just as it had made trade checks with retailers who purchased from Topper, it had made a brief and routine credit check with Topper's lead lending bank which was answered honestly and in good faith. (A27, n. 8)

Significantly, the opinion below states:

> "Upon our view of the facts, there really is no law to discuss." **

Because plaintiffs' brief sets forth what can most charitably be described as a one-sided story, this brief presents a counterstatement of issues and a rather detailed statement of facts.

## COUNTERSTATEMENT OF ISSUES PRESENTED FOR REVIEW

1. Did Citibank owe to any of the plaintiffs a duty of disclosure under the federal securities laws with respect to the Private Placement, in view of the fact that Citibank was merely a lender to Topper and had no involvement in the Private Placement? (Point I)

2. Was the District Court clearly erroneous in finding that Citibank—in its sole contact with any of the plaintiffs regarding the Private Placement, namely, the Pension Fund's brief telephonic "credit check" with Citibank—

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* The other plaintiffs had no contact at all with Citibank and no document in their files referred to Citibank.

** (A28). Rule 52(a) FRCP states as follows with respect to the effect to be given the District Court's factual findings:

> "Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge of the credibility of the witnesses."

acted in good faith and thus without the *scienter* necessary to constitute a breach of any alleged duty under the federal securities laws? (Point II)

3. In view of the District Court's findings as to the lengthy investigation of Topper by the Pension Fund and the factors actually considered by the Pension Fund when it approved investment in the Private Placement, and in view of the complete lack of contact between Citibank and any of the other plaintiffs regarding the Private Placement, can any plaintiff be said to have justifiably relied upon the Pension Fund's brief telephone contact with Citibank? (Point III)

4. Was the District Court clearly erroneous in finding that Citibank did not have or exercise control over Topper's management or policies, that Citibank acted in good faith, and that, accordingly, Citibank was not liable as a "controlling person" within the meaning of the federal securities laws? (Point IV)

5. Was the District Court clearly erroneous in finding that the telephonic "credit check" made by the Pension Fund to Citibank was not understood or intended by either party to be within the scope of the Custodian Agreement between the Pension Fund and Citibank and that no special duty arose from that Custodian Agreement? (Point V)

## STATEMENT OF FACTS

### Citibank and Topper

From 1966 to 1971 the Hubshman Factors division of Citibank administered a revolving demand loan to Topper. Under the Financing Agreement the loans of the Lending Banks, with Citibank as agent, were secured by all assets of Topper, including accounts receivable, inventory, machinery, equipment and cash. (Fdgs D1-D2, D7) The initial loan was $20 million. (D Adm 17, A2406) In August

1971, when Thompson recommended investment in Topper, these loans approximated $20.3 million. (A3528)*

The Topper loan was a non-notification arrangement under which Citibank had no right to deal directly with any of Topper's customers. Topper itself made all collections from its customers and delivered them to Citibank pursuant to its assignment to Citibank of its accounts receivable. (Fdg D8) Citibank's only contact with Topper customers was through confirmations which made no mention of Citibank and were sent out under the name of Henson Associates, Inc., seeking confirmation that the customer's records of what Topper sold it accorded with Citibank's records. No problems in Topper's accounts receivable ever appeared from the returns of these confirmations. (A1280-A1281)

Advances to Topper were roughly measured by (1) a formula providing for loans equalling 80% of "eligible" Topper receivables and (2) amounts advanced from time to time based on non-receivable assets. (Fdgs D3-D4) During almost the entire loan, advances were substantially higher than 80% of Topper's eligible accounts receivable. It was normal for Topper to be in such an "overadvance" position. (Fdg D15; A3793-A3799)** Overadvances existed when Topper sales and collections were both ahead of and behind Topper's projections. For instance,

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*For most of 1971, advances to Topper under the Financing Agreement were made by Manufacturers Hanover (43%), Citibank (37%), Mercantile Bank of Canada (5%) and Fidelity Union Trust Company as a participant in Citibank's advances (15%). (Fdg D15) However, on September 17, 1971 (11 days prior to the Private Placement), Ford Motor Credit Corporation ("Ford Motor Credit") advanced $7 million to Topper, which was also secured, on an equal footing with the Lending Banks' advances, by virtually all of Topper's assets. (Fdg D13)

**The term "overadvances" merely indicated advances to Topper in excess of 80% of eligible receivables. (Fdg D15) Since advances were secured by all receivables as well as other assets of Topper (Fdg D2), the existence of "overadvances" was perfectly consistent with an excess of collateral over loans. (Fdgs D15, D47) Also, in the Finance Agreement, Topper represented that its accounts receivable were valid and collectible. (Fdg D6)

on April 30, 1971, at a time when Topper sales and collections were both well ahead of projection, Topper received overadvances of $3,630,504. (A3797; *see also* Fdg D16)

The Lending Banks' loan to Topper and its administration by personnel at Citibank constituted a typical commercial finance relationship. (Fdgs D17, D23) Aside from the normal contacts with Topper required of it as agent bank, Citibank had no relationship with Topper. Topper's checking account with Citibank was inactive, its active account being with Manufacturers Hanover. (Fdg D7)

Under the Financing Agreement Citibank exercised no control over Topper's business or marketing practices or over its management or policies in general. Even when Citibank declared ineligible for advances receivables which were subject to Topper's various marketing practices, Topper nonetheless continued such practices. (Fdg D20) Citibank exercised control solely over the disbursements of funds to Topper by the Lending Banks and did not control Topper's receipt of funds from elsewhere. (Fdgs D18-D23) In short, the Citibank-Topper relationship was no different from any normal commercial lending relationship or from the relationship which would have existed had Topper financed its business through an independent commercial finance company. (Fdg D7)

**Topper Financings**

In addition to funds received from the Lending Banks, Topper, with the aid of Hayden Stone, obtained funds from time to time through private placements from various individuals and institutions and through public offerings of securities. (Fdg D25)

Due to Topper's financial condition at the time Henry Orenstein re-acquired it from Philadephia and Reading, Topper desperately needed capital in addition to the Lending Banks' loan. Its first acquisition of such capital was in late 1967-early 1968 when Topper sold $2,220,000 junior par-

ticipations in the Lending Banks' loan through a financing handled by Hayden Stone. (Fdg D26)

Three Topper private placements of debt securities, all arranged by Hayden Stone, took place between 1968 and 1970. The rights granted to the participants in such private placements were subordinate to the rights of the Lending Banks, which continued to have all of Topper's assets as collateral for their advances to Topper. (Fdg D27) As contemporaneous memoranda show, Citibank was advised after the fact as to Topper's decisions to enter into these financings. (Fdg D29; A3742)

In June 1970, Topper had its first public offering of securities (Fdg D30). In April 1971, Topper had a second public offering of securities. (Fdg D31) Hayden Stone acted as Topper's lead underwriter in both public offerings. No person from Citibank participated in any way in these public offerings or had any contact relating thereto with either Hayden Stone or Arthur Young & Company ("Arthur Young"), Topper's accountants. (Fdgs D30, D32)

Citibank personnel were first advised in February 1971 of a possible Topper long-term loan. This loan, which eventually became the Ford Motor Credit Company ("Ford Motor Credit") loan, was further discussed by Topper with Citibank in June, 1971. At that time, Citibank was advised that, subject to the Lending Banks' consent, Ford Motor Credit's advances under the loan were to be secured, on an equal footing with the Lending Banks' advances, by Topper's assets. (Fdg D33)*

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* When advised that the Ford Motor Credit loan would decrease the amount of the Lending Banks' advances to Topper, Citibank expressed its disappointment and demanded that Topper pay Citibank a service fee covering Ford Motor Credit's advances to Topper. In early September 1971, Citibank also terminated the participation of the Mercantile Bank of Canada in its loan to Topper because there would be insufficient income to be shared by the banks once the Ford Motor Credit loan became effective. (Fdg D34; A1213) This termination of Mercantile increased Citibank's share of the loan to Topper. (Fdg D14)

**The Private Placement—Citibank's Lack of Involvement**

When Topper advised Citibank in June 1971 of the Ford Motor Credit loan negotiations, it also told Citibank that it was preparing for the Private Placement. (Fdg D35)

Topper originated the idea for the Private Placement, discussing it with Hayden Stone in late 1970 or early 1971. (Fdg D36) Topper wanted the Private Placement in order to have lower interest costs, to obtain unsecured financing and to finance its expansion. (Fdg D37) Citibank did not tell Topper to have the Private Placement or insist that Topper do so; Topper simply advised Citibank of its plans. (Fdg D38)

As with the other Topper non-bank financings, no representative of Citibank participated in any way in the preparation or distribution of any of the many materials distributed to plaintiffs by Topper or Hayden Stone relative to the Private Placement or took part in or was present at any of the numerous meetings and conversations between Topper, Hayden Stone and the plaintiffs concerning the Private Placement. (*Ibid.*) Prior to the Private Placement no representative of Citibank saw any of the many materials distributed to or reviewed by any plaintiff in connection with the Private Placement or knew that any such material had been so distributed. (*Ibid.*)

For instance, the Private Placement was the subject of a 29-page brochure dated July 1971 ("Private Placement Memorandum") (A2727-A2796), which was distributed by Hayden Stone to potential participants in the Private Placement, including plaintiffs. Included in the Private Placement Memorandum was the 37-page Topper April 29, 1971 public offering prospectus ("April 1971 Prospectus"), including Topper's audited financial statements for fiscal year 1970, certified to by Topper's accountants, Arthur Young & Co. ("Arthur Young"). Citibank took no part in the preparation or distribution of the Private Placement Memorandum. In fact, no representative of Citibank was

even aware of or saw the Private Placement Memorandum prior to the Private Placement. (Fdg D38)*

The Private Placement was also the subject of a 28-page agreement between all plaintiffs and Topper dated September 28, 1971 ("Private Placement Agreement"). (A3453-A3514) Citibank took no part in the negotiation or preparation of the Private Placement Agreement. No person at Citibank even saw the Private Placement Agreement until after the Private Placement. (Fdg D38)**

In short, no person at Citibank had any knowledge whatsoever about what information regarding Topper was given to or not given to or reviewed by or not reviewed by any plaintiff. (*Ibid.*) The Private Placement was a deal negotiated and closed by Topper, Hayden Stone and plaintiffs with respect to which Citibank had no influence and no involvement.

**Topper in 1971**

Plaintiffs' brief paints a misleadingly rosy picture of Topper's financial history, together with a misleadingly bleak picture of Citibank's opinion of Topper in 1971. In truth, things had not been so good and were not so bad.

Prior to 1971, Topper's business fortunes were typical of the toy business, which was highly speculative and seasonal. (Fdg D42) For instance, prior to Orenstein's repurchase in 1966 of Topper from Philadelphia and Reading, Topper had suffered very substantial losses, amounting in 1966 to more than $18 million. (A3800) From 1966 through 1970, Topper's financial situation continued to fluctuate between good and bad times. Topper reported losses in 1967, some gains

* Siegel, account executive on the Topper account, testified that he saw the April 1971 Topper Prospectus, which was an exhibit to the Private Placement Memorandum, but could not remember when. (A1302-A1303) Siegel did not know that the prospectus had been distributed to potential investors in the Private Placement. (A1290)

** Prior to the closing, Topper's counsel sent Citibank two pages of the Private Placement Agreement pertaining to the subordination of the Topper Notes to the Lending Banks' debt. (Fdg D38)

in 1968 and significant gains in 1969, but in 1970 its reported profits dropped 87 percent from their 1969 levels, which the plaintiffs knew. Plaintiffs also knew that the 1970 profits included $14 million in sales, pursuant to a Spring 1971 Program, which were to be paid in May and August 1971. (Fdgs D43, D136) The seasonal nature of Topper's business also continued, with by far the greatest amount of its sales near the end of the year, despite various efforts by Topper to stabilize sales on a year-round basis. (Fdg D44)

Topper's performance under the Finance Agreement was consistent with its financial situation prior to 1971. During such period, Topper's performance in meeting its projected collections was always sporadic, and its cash needs fluctuated considerably, not only seasonally but monthly. (Fdg D45; A2397-A2400, A3804-A3805) As Topper's projected collections failed to materialize, its accounts receivable would become past due, and Topper would require additional funds. In prior years, however, past due accounts had not become bad debts, but had eventually been paid by Topper's customers.* Citibank personnel were not overly concerned by Topper's erratic performance, as it was typical. (Fdg D45)

Citibank, of course, financed Topper on a completely secured basis (Fdg D2) and, from its standpoint, the Topper account in 1971 was a good secured credit. Topper was regarded as a good company with good management. (Fdg D46) Topper had made profits over the last three years and had prospects for improving its performance over the next several years. Citibank had been advised by Topper that it was going to get the license to manufacture certain Sesame Street items, and it felt that this would have a very substantial impact on its sales and profits. Topper's past securities offerings and its July 1971 listing

* Topper's customers in 1971 were "of good quality" with respect to credit worthiness. As a result, Topper's bad debts in prior years had been relatively insignificant. Only one of Topper's accounts during the prior three years had gone into bankruptcy, on which account Topper had recovered more than 50% of the balance due. (Fdg D48)

on the American Stock Exchange likewise had a favorable impact upon Citibank's consideration of Topper. Citibank personnel thought well of the creative ability of Henry Orenstein, Topper's founder and President, and of the financial ability of Jack Rose, Topper's chief financial officer (Fdg D47)

Topper's overall financial results during 1971, even before it began marketing its Sesame Street products, showed Topper to be in at least as good a shape as, if not better off than, prior years. For the off-season period through June 1971 Topper reported a profit of $306,541 compared to losses through June 1970 of $954,000 and through June 1969 of $194,000. (Fdg D49) Consistent with these results, in July 1971 Citibank was advised by Orenstein that Topper had had the best first six months in its history. (Fdg D47) Topper's reported profit through July 1971 was $119,296 compared to a loss through July 1970 of $243,000. (Fdg D49)

During the period from May through September 1971, Citibank was aware of Topper's performance with respect to its Spring 1971 Program accounts receivable which, as noted above, became due for payment in May and August, but was not overly concerned about this matter. After all, Topper had never succeeded in overcoming this seasonal aspect of its business. (Fdg D50)

In addition, Topper's 1970 May dating had not been paid in May. Collections in May 1970, in fact, were only 46 percent of projected collections for that month. The 1970 May dating receivables, moreover, were not collected in the following two months and, as of the end of July 1970, became 60 days or more past due and therefore ineligible for advances. (Fdg D51) So when Citibank became aware in May 1971, as it had in 1970, that that year's May dating receivables were not being paid on time, it was hardly alarming. Similarly, when such receivables were not paid in the following two months and became 60 days or more

past due and hence ineligible as of the end of July 1971, Citibank was not surprised. (Fdg D51)

The amount of Topper's past-due accounts receivable on Citibank's books in August 1971 was not materially more significant than it had been previously in 1971. Citibank's records showed the following percentages of past dues to total receivables:

| | | | | | |
|---|---|---|---|---|---|
| January | 21% | April | 29% | July | 11% |
| February | 19% | May | 28% | August | 28% |
| March | 19% | June | 12% | September | 28% |

As the trial court found, these monthly fluctuations were not abnormal in the Topper account and were no cause for undue concern. (Fdg D52)

Similarly, the amount in July and August of Topper's total ineligible accounts receivable, which included past due receivables, was not materially more significant than in previous months in 1971. The percentages of ineligible to total receivables were as follows (Fdg D53):

| | | | | | |
|---|---|---|---|---|---|
| January | 42% | April | 36% | July | 28% |
| February | 20% | May | 37% | August | 42% |
| March | 24% | June | 25% | September | 29% |

During all this time, of course, the Lending Banks were more than adequately secured. (A1168, A2499-A2500, A3792)*

When the May 1971 receivables were not paid when due in May, Citibank discussed the matter with Jack Rose, Topper's chief financial officer. The matter was again discussed in mid-July 1971, when representatives from

* These percentages as found by the Court differ from the percentages portrayed on PX 1442, attached by plaintiffs to their brief. The differences are explained in large part by plaintiffs' non-representative selection of dates and also by certain "adjustments" of the figures on Citibank records. The result of such "adjustments", of course, is to decrease the applicable percentages in early 1971 and to raise the applicable percentages for July and August.

Citibank and Topper had a meeting to bring Citibank up to date and at which Topper requested overadvances from the Lending Banks. Aside from advising Citibank that they had received a commitment from Ford Motor Credit to borrow $7 million from it and were planning to enter into the Private Placement, Orenstein discussed Topper's six-month earnings, Sesame Street, and the subjects of collections and overadvances. (Fdg D55; A2872-A2873)

Concerning Sesame Street, Orenstein advised Citibank that the line was being finalized and that 1971 sales, which he anticipated would be between $8 and $10 million, would start soon. Orenstein said that this new line of merchandise would afford Topper a tremendous advantage in selling its regular toy line. (Fdg D56) Waldman understood that one reason Topper was requesting additional advances was to make its new line operational. (A1375-A1376)

With respect to collections, Topper indicated that some of its distributors had not been paying their bills because the merchandise had not been sold. Citibank's records showed that $3.5 million accounts receivable were more than 60 days past due, and that $6 million more would become past due if not paid by the end of July. Citibank suggested to Topper that it take a harder stance with its customers as to collections. Orenstein said that this would be the wrong approach at that time because of the effect upon the good will of the customers and because the Sesame Street line would give Topper leverage in effecting its collections. Orenstein preferred to effect collections more in accordance with Topper's normal seasonal patterns. (Fdg D57)

Orenstein said, however, that collections could be effected right away if Citibank insisted that Topper take a hard line with its customers. Citibank did not insist, but acquiesced in Orenstein's decision not to push for immediate payment by Topper's customers. (Fdg D57) At this time, it is noted, there was a severe credit crunch, during which many companies were investing all available funds

instead of paying bills, and many other companies, consequently, were very hard pressed to effect collections. (Fdg D58)

Accordingly, when approximately $6 million of Topper accounts receivable became past due in August, this event did not concern Citibank because it was foreseen and had already been discussed with Topper. (Fdg D54) In short, the Topper account, which continued to be heavily collateralized (A3792; Fdg D47), had no special problems which were or which should have been cause for undue concern on the part of Citibank. (Fdg D59)

Judge Knapp summarized the situation as follows:

> "In 1971, . . . [Topper] sales turned sluggish and Topper's past due accounts receivable began to rise rather precipitously. Citibank, which kept careful watch over Topper accounts receivable, instantly became aware of this situation and urged Topper to bring pressure on its customers to pay down their accounts. Orenstein agreed to do this if the Bank insisted, saying that the accounts could easily be cleaned up in a matter of weeks. However, he strongly advised against such a course on the ground that it would put Topper at a competitive disadvantage with more lenient manufacturers. Since Citibank was confident of the customers' credit it accepted Orenstein's judgment and did not press for immediate collection. It was not until December of 1971, three months after the private placement, that Citibank began to discover that the accounts were not only uncollectible but non-existent." (A24)

**Topper Practices Unknown to Citibank**

Unknown to Citibank, some of Topper's officers had secretly engaged in certain business practices which made Topper's financial situation less stable than it appeared. Among the methods devised were the granting, at the time of sale, to customers of certain rights and concessions pur-

suant to which customers were entitled to exchange Topper Spring 1971 Program merchandise for other merchandise, to redate such merchandise (pay for it later) or, in some cases, to return it to Topper for credit. (Fdg D108; A3272-A3293, A3331-A3354, A3357, A3364, A3371, A3349, A3452) Topper confirmed exchange rights in writing to at least 26 customers in late 1970 or early 1971 (P Adm 133, A1711), and issued additional exchange letters during 1971 to induce certain customers to accept Topper merchandise sold at the time. (Fdg D108)

In addition, Topper secretly agreed with several customers, many of whom had received letters confirming a future exchange privilege, that merchandise warehoused for them by Topper was to be paid for only when the customers withdrew it from Topper's facilities or, in some cases, exchanged it for other merchandise. (P Adm 162-163, A1718-A1719) Merchandise shipped under the Spring 1971 Program was, however, reported as a sale at the time of delivery to the customer or to a Topper warehouse, whether or not subject to a future exchange, return or redating privilege. (P Adm 139, 144, A1712, A1714)

Orenstein and Pierce, who was in charge of Topper sales, kept secret from other Topper employees and outsiders the existence of all such written and oral arrangements. Pierce, at Orenstein's instruction, maintained a confidential file in which all such written agreements were kept. (Fdg D109; A3870-A3874) During Arthur Young's 1970 audit of Topper in early 1971, Arthur Young sent requests for confirmation of Topper's accounts receivable to Topper's customers. Topper personnel told such customers not to mention anything about the rights of exchange. (Fdg D110; A2102-A2105) Pierce lied to Arthur Young auditors about the existence of the agreements because he believed they would not amount to anything. (A3874)

No representative of Citibank, which had received Topper's warranty that all receivables were *bona fide* (Fdg D6),

was aware that Topper was extending any rights to return or rights to exchange or rights to redate any merchandise, or that Topper or any of its customers felt that Topper's customers had a right to return or exchange any significant amount of merchandise. (Fdg D111)* Nor were Hayden Stone, Arthur Young, or White & Case, Topper's counsel for the Private Placement, aware of such practices. (Fdgs D112-D114)

As the District Court found:

> "Orenstein devised various methods to entice retailers and distributors to stock Topper toys. All these methods ultimately resulted in the retailer or distributor being able to obtain Topper merchandise—or have it warehoused at Topper expense—upon conditions under which the retailer or distributor paid Topper only when and if the public ultimately bought the toys. The beauty of this arrangement—from the distributor and retailer's point of view—was that he could without risk to himself have a vast array of Topper toys available to be sold, just as if he had ordered them on consignment.
>
> "Shrewdly suspecting that secured creditors and other investors would find these arrangements less attractive than did the retailers, Orenstein arranged Topper books and records so that all transactions were reflected as final sales to its abundantly solvent customers whose shelves were burgeoning with Topper

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* Citibank's procedures and decisions respecting the eligibility of Topper receivables involved in redating, extended dating, warehousing, returns, exchanges and other concessions permitted by Topper were normal and prudent. (Fdg D115) Citibank handled the Topper account in accordance with proper, prudent and professional methods and within guidelines of proper secured financing. (Fdg D24)

toys. Indeed, the customers routinely returned auditors' letters confirming the sales involved." (A23-A24)

**The Pension Fund Investigation of Topper**

The Pension Fund's investigation of Topper prior to the Private Placement was conducted in large part by Henry Thompson, the Pension Fund's investment manager, who was a chartered financial analyst with over 12 years of experience in securities analysis. (Fdgs D116-D118) In short, Thompson's job was to analyze possible investments for the Pension Fund, which invested assets approximating $3 billion. (Fdg D119; A682)

Thompson was not new to the toy industry in 1971, having done research on the industry and having himself invested in one toy company. (Fdg D120) Nor was Thompson new to Topper. In fact, in 1970 Thompson had rejected suggestions, by Hayden Stone and others, that he consider Topper as a possible Pension Fund investment, terming it a waste of time. (Fdgs D121-D123)

In July 1971, however, Thompson was persuaded by Hayden Stone to look into Topper.

Thompson's investigation of Topper was a first hand, in-depth investigation which continued for over one month, only parts of which took 60 to 80 hours of Thompson's time. (Fdg D253) As Thompson himself recalled at trial:

> "Let me put it this way: It was the principal thing that I did during the month of August 1971. 40 times 4 and a fraction, maybe 170 hours, you don't work on this thing all of the time, but. . . ." (A753)

While the extent of Thompson's investigation can only be fully appreciated by a review of Judge Knapp's findings on the subject (Fdgs D124-D253), a brief summary of Thompson's activities is necessary to put in perspective his five minute conversation about Topper with Citibank. (Fdg D233)

Thompson's investigation of Topper commenced with a review of the 29-page Private Placement Memorandum (A2727-A2796), which had been prepared by Topper and Hayden Stone specifically for potential investors in the Private Placement.* This document contained many exhibits, including Topper's 34-page April 1971 Prospectus, which Thompson treated as an integral part of the Private Placement Memorandum. (Fdg D126)

The April 1971 Prospectus, it should be noted, prominently termed an investment in Topper as "speculative in nature" and described in some detail many of the risks involved and the reasons why Topper had done poorly in the past. (Fdgs D127, D131-D132) Thompson himself felt that the principal risk factors were Topper's history of substantial losses, its dependence on demand bank borrowings and the fact that it appeared to be a one-man company. (Fdg D137)

Also prominently mentioned in both the Private Placement Memorandum and the April 1971 Prospectus was Topper's Spring 1971 Program, pursuant to which Topper said it was including as December 1970 sales approximately $14 million of shipments with extended dating terms of five to eight months, which amount was compared to approximately $2 million the year before. (Fdgs D128-D129) Thompson knew, therefore, that $14 million of Topper's $64 million in 1970 sales had been scheduled to be paid in May and August 1971. (Fdg D136) The Private Placement Memorandum stated that the Spring 1971 Program had received an "excellent reception," a fact which stood out in Thompson's mind and on which he focused. (Fdgs D134-D135)

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* The Private Placement Memorandum specifically stated that the proceeds of the Private Placement were to be used to reduce Topper's bank indebtedness (Fdg P15), and there was no doubt in Thompson's mind throughout his investigation that the proceeds of the Private Placement were to go to the Lending Banks. (A681-A682)

Thompson continued to inquire as to these subjects throughout his investigation, which next encompassed a full-day meeting with Hayden Stone and Topper officials, including a trip to Topper's plant in New Jersey (Fdgs D142-D164) on August 4, almost three months after the May 1971 Spring Program receivables had been scheduled for payment. At Thompson's early morning meeting that day with Hayden Stone, for instance, Hayden Stone explained to Thompson that Topper's Spring 1971 Program was the big change from its past and would stabilize Topper's seasonal sales pattern. (Fdg D142) Accordingly, Thompson quizzed Hayden Stone on the reception that program was receiving. He was told that Hayden Stone had assured itself that the Dawn line was selling well at retail, that Topper was actually ordering more Dawn dolls, and that the Spring 1971 Program had been very successful. (Fdg D143)

Shortly thereafter, Thompson raised the same subject upon his first meeting with Orenstein. Orenstein, with Hayden Stone's express concurrence, reaffirmed that Dawn was selling well. (Fdgs D146-D147) Upon arrival at Topper's New Jersey plant, and later during lunch, Thompson again discussed the Dawn line with Orenstein. (Fdgs D150, D159-D160)

These instances are just examples: the District Court's findings mention over 10 separate occasions on which Thompson or his fellow analysts at the Pension Fund discussed the success of the Spring 1971 Program or the Dawn line of merchandise. (Fdgs D143, D146-D147, D150, D159-D160, D181, D184, D186, D196, D242) At no time, however, did Thompson actually check the Topper financial documents which would have enabled him definitively to check the continually rosy assurances that he received concerning Dawn and the Spring 1971 Program. In fact, during Thompson's August 4 visit to Topper, Rose discussed in detail a number of documents regularly prepared by Topper in order

to control its inventories and accounts receivable, but Thompson did not review any such documents. (Fdgs D152, D154)*

As Judge Knapp stated:

> "None of these investigations brought to light the condition of the accounts receivable. He came close to such a discovery during a visit to Topper's offices. He there asked Rose to let him see some of the actual documents concerning receivables. However, that question came up just before lunch. Rose impressed upon Thompson the importance of their luncheon appointment with Orenstein, and the subject was never again mentioned." (A25)

The situation was very much the same with respect to Thompson's inquiry into the events which had caused Topper financial problems in the past and what Topper was doing in 1971 to prevent their repetition. The April 1971 Prospectus had specifically explained that one reason for the disastrous losses Topper had previously suffered had been Topper's practice of selling on consignment. (Fdg D133) As with their inquiry into the success of the Spring Program, Thompson and his fellow securities analysts at the Pension Fund repeatedly sought specific assurance from Topper, Hayden Stone and many others as to whether Top-

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* One such document was a monthly aging report, which showed a list, by customer, of receivables which were current, less than 30 days past due, 30 to 59 days past due and 60 days or more past due. (Fdgs D152, D154-D155) The July 31, 1971 aging report showed $8,513,356.13 of receivables 60 days or more past due and an additional $2,947,460.24 otherwise ineligible for advances. (A2700) Another document which Thompson requested at least three times but never received was Topper's latest financial statements. (D209) Had he received Topper's July 31, 1971 financial statements (A2660-A2669), which were available prior to the closing of the Private Placement (PX 455, Addendum A4), he would have known, among other things, that Topper suffered a net loss for the month of July (A2664) and that its maximum bank loans under the Financing Agreement had been increased during July to $21 million (A2665), facts which plaintiffs claim Citibank should have disclosed to them.

per's consignment practices still existed. And as with the reports on Topper's Spring Program, Thompson was repeatedly assured by Topper and Hayden Stone representatives that consignment selling had been discontinued and that all sales were final. (Fdgs D153-D156, D192, D244)

As the District Court noted, however, Thompson neglected to verify the finality of Topper sales by a review of any contracts between Topper and its customers or to ask the people who were best qualified to comment thereon—Topper's customers. Thompson talked to two of Topper's major customers shortly after his trip to Topper. (Fdgs D181-D189) Thompson did not question these customers concerning the finality of Topper's sales because he had already gotten assurances from Topper as to this matter. (A605-A606)

Thompson simply did not pay attention to or follow up on warnings he received during his investigation. For example, Thompson read a *Wall Street Journal* article (A3814) about Topper in which three investment analysts were described as recommending against investment in Topper or recommending that it be held only as a speculation. One such analyst was cited for his conclusion that Topper's $14 million of sales with five to eight months extended dating amounted to Topper's customers using Topper to finance their business. (Fdgs D171-D175; A700-A704)

Thompson contacted one of the analysts, William D. Schwartz of Burnham & Company, whom Thompson considered a top toy securities analyst. (Fdgs D178-D179) Schwartz advised Thompson against participating in the Private Placement and said he had given the same advice to five or six other persons who had contacted him. Thompson did not ask who they were. (Fdg D178) According to Thompson's contemporaneous memorandum of the conversation (A3525), Schwartz told Thompson that he rated Topper "poorly with regard to its candidness to the investment community" and cited an instance where he felt

Orenstein had misled him in 1970. Thompson discounted Schwartz' warnings because he felt that Schwartz was biased in favor of Mattel, Topper's largest competitor. (A3525)

The *Wall Street Journal* article also implied a much less exclusive arrangement between Topper and Sesame Street than Orenstein had led Thompson to believe (Fdg D171), so Thompson checked with the Sesame Street licensor. (Fdg D177; A3525) In his memorandum of that conversation, Thompson also noted that a fellow analyst at the Pension Fund had learned that some toy licensees refused to do business with Topper, but Thompson did not follow up on the statement. (Fdg D218)

Similarly in one of his phone conversations with toy buyers, Thompson was told that the trade wanted to do business with Topper because the trade was angry with Mattel for loading it up with goods that the trade had not really wanted and Mattel had not made it up to the trade. (A603-A604; Fdg D181) Despite this implication that Topper was not being as hardnosed as Mattel, Thompson did not follow it up. (Fdgs D183, D185, D187; A602, A605-A606) As Thompson himself later wrote, had he known more about the toy business he would have been more alert to explore Topper's return and exchange policies further. (PX 1398)*

On August 13, 1971 Thompson and Harrison, his fellow analyst, who had also reviewed the Private Placement Memorandum, met with Rose and Downs for several hours and discussed many aspects of Topper's business. (Fdgs D194-D200, D214, D216) The bulk of the meeting was spent reviewing and discussing Topper's "Examples of Com-

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* Thompson's investigation included contacts with Glover Johnson, a Topper director and the White & Case partner who had handled the purchase of Topper from Philadelphia and Reading. Johnson told Thompson that Topper had gotten into trouble in the past by shipping on consignment in December and recording such shipments as sales and profits for December, and that Orenstein had put an end to the practice. (Fdg D192; PX 1377)

pany's Reporting" (PX 1459, A3605-A3610), which in addition to including Topper's monthly financial statements through June 30, 1971,* also included several examples of Topper's records on accounts receivable and returns. Thompson never asked to see in full any of these reports.** (Fdg D207) He believed that the Examples of Company's Reporting showed that Topper had good controls over its inventories and receivables. (Fdg D208)

Thompson dictated a memorandum shortly thereafter in which he summed up his feelings as follows:

> "This situation is somewhat offbeat for the Pension Fund but I think that it is quite interesting. The Company has the ability to adjust its cost structure rapidly to changing market conditions and appears to be a better credit risk than would be thought for the toy industry. Moreover, management has been uniformly impressive and the basic business appears to be in an uptrend which could prevail for some time. On this basis, we believe that the risk/reward relationship is favorable and that the Pension Fund could invest $3 million in the convertible debenture without undue exposure." (Fdgs D210-D211; A3528-A3531)

Harrison also wrote a memorandum recommending the Private Placement as an appropriate investment for the Pension Fund. (A3559; Fdg D217)

After their investigation, Thompson and his fellow analysts themselves considered Topper an "intriguing,"

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* Topper's June 1971 financials showed gross sales of $21 million, net sales of $19 million and outstanding accounts receivable of $29 million—which figures Thompson did not try to reconcile. (Fdgs D201-D203)

** These included examples of (1) accounts receivable aging reports, by customer and invoice (Fdgs D200, D206; A3608-A3610); (2) customer contract listings (which made numerous references to Topper's "bill and hold" receivables) (Fdg D204); and (3) credit summaries, showing all returns processed by item for the day, month to date and year to date. (Fdg D205; A3606-A3607)

"offbeat," "interesting" investment in an industry "similar to the garment business," which was justified, nevertheless, by the "high expected payoff." (A3516, A3530, A3559)

**Waldman-Thompson Phone Call**

With this background, Thompson's five-minute telephone conversation with Edward Waldman on August 27, 1971 can be properly evaluated.

In mid-August 1971, Thompson had mentioned to George Nelson, a former vice-president and consultant to the Pension Fund, that he wanted to invest in Topper and asked Nelson's advice on how best to approach Thompson's boss, Molé. (Fdg D219; A2053-A2054, A2058-A2059) When Thompson mentioned to Nelson that Citibank was Topper's lead bank, Nelson suggested that Thompson check with Citibank. (Fdgs D220-D221; A2054, A2058) Orenstein had told Thompson that Waldman was the person at Citibank in charge of the Topper account, and Molé told Thompson that he should contact Waldman through Walter Jeffers, who was employed in the commercial lending part of Citibank as head of the Metals and Mining Department, and who had been handling major corporate accounts in the metals and mining industries, including the United States Steel Corporation account, since early 1970. (A25-A26) On August 25, 1971 Thompson called Jeffers, who called Waldman, told him that Thompson of the Pension Fund had called about Topper and asked Waldman to call Thompson. Waldman assumed that the Pension Fund was a large depositor of Citibank. (Fdg D232; A1376-A1377)

Waldman in 1971 was a vice-president in charge of the Hubshman Factors department of Citibank and had supervision over 150 accounts, of which Topper was the largest. He spent approximately 5 per cent of his time on the Topper account, meeting from time to time with Orenstein and discussing the account on a regular basis with Lusk, the division's credit manager, and Siegel, the Topper account executive. (Fdg D9) Waldman called Thompson on August

27, 1971, saying he was replying to Jeffers' request to call Thompson. Thompson told Waldman he was an investment manager at the Pension Fund and was considering an investment in the Private Placement. (Fdg D233)

Thompson asked Waldman a few questions about Topper. (Fdg D233) The District Court described the Thompson-Waldman phone call as follows:

> "In essence, Waldman toid Thompson that—from his point of view as a secured lender—Topper's was a wholly satisfactory account and that he neither knew of nor foresaw any problem. In response to Thompson's request for investment advice, Waldman said he was in no position to give any." (A26)

The Court specifically found that Waldman acted in good faith in his conversation with Thompson (A27), gave honest answers to Thompson's questions, and "told the truth." (A1601; Fdg D235) The Court found that there was no discussion of financial condition or whether there were any problems in connection therewith but rather only whether there were problems in Citibank's relationship with Topper. (Fdg D234)

Thompson did not ask Waldman whether Topper's sales were on consignment or final. (A631-A632) His reason for not asking was that he had already been assured on this subject and did not think it was a matter in Waldman's area. (*Ibid.*) Nor did he ask Waldman any other details about Topper's receivables, such as what portion was ineligible or whether the Lending Banks advanced in excess of the $18.5 million limit stated in Topper's June 30, 1971 financials or of 80% of eligible receivables.* In fact, Thomp-

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* Thompson knew the loan balance was $20.3 million. (Fdg D212; A3528) In addition, the Pension Fund's counsel for the Private Placement knew that there had been a temporary increase in the Lending Banks' overall credit line by amendment to the Financing Agreement prior to the Private Placement. Finally, the Private Placement Agreement stated that Topper had furnished copies of all amendments to the Financing Agreement to each purchaser. (¶ 5.5, A3457; Fdg D250)

son never asked about receivables or collections at all. Thompson simply asked if there were any problems in the Topper account and waited for Waldman to qualify his "no" answer. (A634-A637)

Judge Knapp commented as follows concerning the phone conversation, which he found took five minutes (Fdg D233):

> "At trial the plaintiff—through testimony of Thompson and cross-examination of Waldman—attempted to create the impression that this conversation was both lengthy and involved. We have concluded that nothing of any consequence was said in the course of the conversation which is not reflected in . . . the contemporaneous report that Thompson made to his superior, Molé." (A26, n. 7)*

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*Thompson's contemporaneous report stated in full as follows:

"Mr. Waldman, a First National City Bank loan officer, who handles the Topper account, called me at the request of Walter Jeffers on Friday. He indicated that FNCB has a 40% participation in a banking line with Topper in which it lends up to 80% of eligible accounts receivable. He did not know the current amount of the loan but thought it to be several million dollars.

"Mr. Waldman indicated that the bank is lending at 3% over its prime rate without any compensating balances so that it is currently providing funds at 9% to Topper. I asked him why the Ford Credit rate is so high and he said that several years ago, Ford Credit gave its money away but that this policy has changed 180° in the past few years. In his opinion, the 14% maximum rate is high but not out of line and he feels that longer term money in this situation deserves a significant premium over normal commercial banking rates.

"FNCB, as part of its lending functions, performs audits of Topper and Mr. Waldman said that this is one of the reasons that his bank does not lend at a lower rate. Management has shown itself to be competent and to have good controls in these audits. The bank rates Topper above-average with respect to the other toy companies with whom it deals and Mr. Waldman believes Jack Rose of Topper to be a very competent financial officer. The relationship between FNCB and Topper has been good and there are no problems at the moment nor does Mr. Waldman anticipate any.

"FNCB believes Mr. Orenstein to be extremely important on the marketing side of the business, but indicated that the company

As to the Pension Fund's claim that Waldman should have brought up the rise in Topper's past due accounts receivable, the District Court concluded as follows:

> "At the close of trial, counsel for plaintiffs strenuously argued that the critical fact was not the invalidity of the accounts, but Topper's easy practices with respect to returns (Tr. 1419). That argument has now been abandoned. Plaintiffs continue to urge that the Bank (i.e. Waldman) should have alerted plaintiffs (i.e. Thompson) to the fact that past due accounts were growing at an 'alarming' rate. The difficulty with both arguments is the same. Waldman saw nothing alarming either in the easy return policy or in the past due accounts. He had been convinced by Orenstein that both were sound business practices. Moreover, believing that substantial and knowledgeable retailers such as Kresge and Sears had committed their credit to the purchases involved, the Bank was entitled to assume that these retailers had confidence that the merchandise would ultimately be sold. In any event there was no occasion—in the brief conversation described in Plaintiff's Exhibit 1379—for Waldman to get into any philosophical discussion of Topper's business practices." (A30, n.10)

**Citibank and the Pension Fund**

Citibank and the Pension Fund were parties to a Custodian Agreement dated November 30, 1950, as amended ("Custodian Agreement") (A3653-A3657), providing that

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has done an excellent job of estimating cost of production for new toys. Mr. Waldman was aware that most of Topper's new items were developed by others than Mr. Orenstein and believes it is lessening its dependence upon him.

"On balance, the bank thinks well of the company and that it rates highly among the managements of companies in the toy business. On the other hand, Mr. Waldman was unwilling to commit himself outright as to whether the toy business is one in which we should commit funds and, in fact, ducked this part of my inquiry." (A3532)

Citibank was to act as joint custodian with Morgan Guaranty, which had an identical agreement with the Pension Fund, for the assets of the Pension Fund. (Fdg D269) By agreement, Citibank was paid according to the value of the assets held. (Fdg D268) Pursuant to its agreement with Topper, Citibank carried out numerous custodial and administrative duties as to the assets. (Fdgs D270, D272)

In addition to prescribing in some detail the custodial and administrative duties of Citibank concerning the Pension Fund's account, the Custodian Agreement stated that Citibank agreed to provide the Pension Fund with "investment advice with respect to . . . securities held . . . in the custodian account or . . . cash held . . . for investment."*

Citibank's rendering of "investment advice" under the Custodian Agreement consisted of four meetings a year of four or five of its senior economists with the investment officers of the Pension Fund to discuss general economic trends and Citibank's current investment policies regarding its holdings in the equity and long and short term bond markets. (Fdgs D274-D275) Thompson's inquiry through Jeffers to Waldman, who did not know of the custodial relationship between the Pension Fund and Citibank, was not a request for investment advice, but was rather a routine credit check which, like the various trade checks made by Thompson, was standard Pension Fund practice and which would have been made under any circumstances with Topper's banking contacts. (A27, fn. 8; A2338; Fdgs D236-D239)

Consistent with his practice in handling credit inquiries, Waldman specifically refused to respond to Thompson's question whether Topper was a good investment and confined himself to a general description of Citibank's relationship with Topper. (Fdgs D233-D234, D238; A3532) Molé, the Pension Fund's president, told Thompson he had no business asking Waldman whether Topper was a good

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* Citibank had no discretion to invest. (Fdg D271)

investment. (Fdg D238) Accordingly, in his decision memorandum (A3515-A3516), Thompson categorized his "banking checks" with Citibank and Manufacturers Hanover as equivalent to his "trade checks" with Topper's customers. (Fdg D247) Similarly, in subsequent memoranda he referred to the call as "our credit check". (A3817, A3819) Clearly, Thompson was not seeking investment advice from Waldman.

In his opinion, Judge Knapp stated that

> "In making the call to Jeffers neither Molé nor Thompson (nor their employer, the Fund) was seeking investment advice pursuant to the advisory contract or any special relationship the Fund had with the Bank. . . . Neither Jeffers nor Waldman nor anyone connected with the Bank either believed or had reason to believe that the Bank was giving or had been asked to give investment advice pursuant to the investment advisory contract or any other special relationship between the Bank and the Fund." (A28)

Jeffers and Waldman treated Thompson's phone call as the routine credit inquiry it was. Waldman's conversation with Thompson was consistent with Waldman's and the factoring division's practice, which was to describe the security and the appropriate amount of the advance and to state whether the relationship was satisfactory. (Fdg D239)

**Events Subsequent to the Private Placement**

According to Thompson's own analysis, Topper's financial statements for the nine months through September 30, 1971, supplied to the Pension Fund in October 1971, "showed a soundly financed company with improving earnings" (A3538) and "further profit gains and an increase in net worth." (A3542) They were reportedly the best nine months' sales and earnings in Topper's history. (Fdgs D254, D409)

During the fall of 1971 *Toy & Hobby World* continued to report that certain of Topper's products, including

Dawn, were doing well and various securities analysts continued to be optimistic about Topper's earnings. (Fdg D413)

After the Private Placement Citibank continued to make regular advances to Topper until December 17, 1971, when it first became aware of Topper's serious financial problems. (Fdg D407) In addition to the $400,000 it advanced at the end of September 1971, Citibank made advances to Topper during October 1971 which totalled $7.3 million and advances during November 1971 which totalled $5,450,000; during the first 17 days of December Citibank's advances to Topper totalled $2,275,000. From early November, 1971 throughout the remainder of 1971, the Topper loan account was in an "overadvance" status. (Fdg D408)

The 1971 Christmas season and, therefore, 1971 in general, was a very bad season for all of the major toy manufacturers. Mattel, for instance, suffered a net loss from continuing operations (before income taxes) of over $50 million for its fiscal year ending after the 1971 Christmas season, compared to net income of approximately $36 million the year before. (Fdg D414; A3771-A3772; see also Fdg D309)

On December 2, 1971 Topper announced that its results for 1971 would be disappointing (Fdg P196), and on December 17, 1971 that it would suffer a substantial loss. (Fdg P197) Following an investigation thereafter, Arthur Young in early 1973 withdrew its certification of Topper's 1970 financials. In May 1973 Topper was adjudged a bankrupt. (Fdgs P207-P208)*

* Several Pension Fund memoranda were written about Citibank after Topper's problems surfaced. One (¶ 5, A3534) stated that the Pension Fund "would not directly ask the banks to repay [it];" another reflected Molé's view that Citibank "had not foreseen the extent of Topper's problems. . . ." (A3612; Fdg D261) One more said that Molé did "not believe that Mr. Waldman had any inkling that the company would get into difficulties within three months' time [when he talked to Thompson]." (A3815; Fdg D262; see also Fdg D260; ¶ 7, A3544-A3545; Fdg D264)

**Lending Banks' Loss**

The Lending Banks lost approximately $10.9 million on their loans to Topper under the Finance Agreement. Citibank's share of that loss exceeded $3 million. (Fdg D415)

## ARGUMENT

### I. Citibank Did Not Owe Planitiffs Any Duty under the Federal Securities Laws.

Plaintiffs' "basic premise" that Citibank owed a duty of disclosure to plaintiffs was dealt with by the Court below under a flexible standard derived from *White* v. *Abrams*, 495 F.2d 724 (9th Cir. 1974). Under that standard, urged upon the Court by plaintiffs, Judge Knapp found that such duty of disclosure did not exist. (A28-A30) This decision was correct.

The only direct federal securities violation charged to Citibank is a violation of Section 10(b) of the Exchange Act.* While Section 10(b) states that "any person" may be found liable thereunder, and the statutory language limiting liability to one who acts "in connection with the purchase or sale of any security" has been expanded beyond a standard of strict privity, it has been necessarily limited to defendants with a special relationship to the issuer of the securities sold or a special relationship with an investor as to such securities. *See Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (1961) (insiders); *Fischer* v. *Kletz*, 266 F. Supp. 180 (S.D.N.Y. 1967) (accountants).

The proper approach towards application of these principles is found in this Court's admonition that in any Section 10(b) case, "[t]he initial inquiry . . . is what duty of disclosure the law should impose upon the person being

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* Contrary to implications in Plaintiffs' Brief (pp. 17-29), they do not charge Citibank with a direct violation of Section 17(a) of the Securities Act. Plaintiffs allege only that Citibank aided and abetted Topper and Orenstein in their violation of Section 17(a). (Complaint, ¶ 72, A20t-A20u) See p. 39, fn. *infra*.

sued." *Chris-Craft Industries, Inc.* v. *Piper Aircraft Corp.*, 480 F.2d 341, 363 (2d Cir.), *cert. denied,* 414 U.S. 910 (1973). *See Carr* v. *New York Stock Exchange*, 414 F.Supp. 1292, 1300 (N.D.Cal. 1976). Considering Section 10(b) liability of an issuer's director, this Court stated as follows concerning the scope of the duty to disclose:

> "We conclude that a director in his capacity as a director (a non-participant in the transaction) owes no duty to insure that all material, adverse information is conveyed to prospective purchasers of the stock of the corporation on whose board he sits. A director's liability to prospective purchasers under Rule 10b-5 can thus only be secondary, such as that of an aider and abettor, a conspirator, or a substantial participant in fraud perpetrated by others." *Lanza* v. *Drexel & Co.,* 479 F.2d 1277, 1289 (2d Cir. 1973) (en banc) (footnote omitted).

Dealing with a Section 10(b) claim against a bank which loaned money to an issuer and was repaid with the proceeds of the plaintiff's investment in the issuer, the Fifth Circuit recently made the following similar analysis:

> "Although the complaint makes allegations of both primary and secondary liability against [the Bank] . . ., the alleged investment contract was clearly between Mrs. Woodward [the investor] and CIC [the issuer], through its agent Starnes. No one suggests either that she was investing in the bank, or that the bank was investing in CIC. The gist of her allegations is that the bank was aiding Starnes in the commission of a fraud; thus it is vulnerable if at all under the secondary liability theory of aiding and abetting." *Woodward* v. *Metro Bank,* 522 F.2d 84, 94 (5th Cir. 1975) (footnote omitted).

Certainly Citibank, as a mere lender to the issuer Topper with no involvement in the Private Placement, should not be

held to a standard of conduct stricter than that set down in these cases. Indeed, imposing a duty to disclose on Citibank under these circumstances would effectively repeal both the "in connection with" language of Section 10(b) and the "good faith" protections contained in the "controlling persons" provisions of Section 20(a) of the Exchange Act. *Cf. SEC* v. *Coffey,* 493 F.2d 1304, 1315 (6th Cir. 1974), *cert. denied,* 420 U.S. 908 (1975).

Still another circuit court, *City National Bank* v. *Vanderboom,* 422 F.2d 221 (8th Cir.), *cert. denied,* 399 U.S. 905 (1970), addressing the question whether the duty of disclosure under Section 10(b) applies to a lender to the issuer by virtue of its receipt of financial or other information pertaining to the issuer in the course of its administration of the loan, held that Section 10(b) was inapplicable to the lender:

> ". . . the alleged fraudulent scheme was not revealed to Ed Smoot, the president of the bank and the bank's representative in the making of the loans [to the plaintiff-investors enabling them to acquire control of the issuer], and that therefore the bank acted *in good faith* in making the loans. From its finding that the bank did not sell or offer to sell any security of any kind to the investors but merely loaned them some of the money with which to buy capital stock . . . , the [District] Court concluded that the bank's behavior in making these loans did not fall within the statutory coverage of the 'in connection with the purchase or sale of any security' clause of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5." *Id.* at 227. (emphasis supplied)

Affirming these findings, the Eighth Circuit stated:

> ". . . we find that the alleged misrepresentations and nondisclosures on the part of the bank do not fall within the statutory coverage of the 'in connection with the purchase or sale of any security' clause. The

defendant investors allege that Smoot misrepresented the financial condition of AHB [parent of the issuer] on October 29, 1965, and that he silently acquiesced to misrepresentations made by Hall on that date when he knew or had reason to know that such representations were untrue, because the bank had in its possession monthly financial reports from PL&I [the issuer] and an Arthur Andersen audit of PL&I completed sometime in October of 1965 and because Smoot was the bank official who oversaw the PL&I account. . . .

"With regard to nondisclosures, the issue becomes whether a reasonable investor, in light of the facts existing at the time of the nondisclosure and in the exercise of due care, would have been entitled to receive full disclosure from the party charged and would have acted differently had the alleged nondisclosure not occurred. . . .

"In applying this test to the instant case, we find a reasonable investor would not have relied upon any representations made by Smoot and that *the bank did not owe a duty of full disclosure to the investors.*

"*The investors had access to all the books and records of AHB and PL&I* during the four-month option period. The investors allege they have never seen the Arthur Andersen audit of PL&I, that it is as yet still undiscovered by them. Regardless of what this audit might show, the fact remains that the audit was made for PL&I—not the bank. The investors either had access to this audit report, which was ostensibly in AHB files, or they had the right to secure it from the auditors. Markham, the investors' agent, knew of the report, had access to it and could have produced it if desired." (emphasis added) *Id.* at 229-231.

As did the court in *Vanderboom,* Judge Knapp found that Citibank owned no duty of disclosure to plaintiffs under Section 10(b) in connection with plaintiffs' investment in Topper. Relevant to his conclusion that Citibank owed

plaintiffs no duty is Judge Knapp's finding that Citibank "was not directly involved" in the Private Placement, as well as the following findings expressed in his opinion:

> "Neither Waldman, Jeffers nor any other officer or employee of the Bank (or the Bank itself) had any conceivable motive to mislead Thompson or the Fund. Any benefit the Bank might have received from the private placement (even if not short-lived as it turned out) would have been insignificant compared to the risk of jeopardizing not only the Bank's investment account with the Fund but its far more substantial commercial account with United States Steel Corporation.
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> "Neither the Bank nor any of its officers or employees either knew or had reason to know of any misrepresentation that Topper may have made to the Fund or to any other plaintiff.
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> "With respect to [relative access] . . . the critical information which Topper withheld from plaintiffs was that its accounts receivable were sham. That information was as accessible to plaintiffs as to the Bank, if not more so. Just as the Bank could have discovered the fraud by insisting upon seeing the actual documentation, so could have the plaintiffs. Furthermore, since the accounts were on a non-notification basis, the Bank was precluded from making direct approaches to Topper customers, an avenue which was clearly open to plaintiffs." (footnotes omitted) (A27-A30)*

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* Thompson was given full access to Topper's books and records and was free to check anything he wanted to check. (Fdg D252; see also Fdg D199) *McLean* v. *Alexander*, 420 F.Supp. 1057 (D.Del. 1976), relied upon by plaintiffs, held that an independent accountant was liable to a purchaser of securities for misrepresentations and omissions in the accountant's opinion respecting an issuer's accounts receivable because the purchaser lacked further access to the information. The case is thus inapposite.

With these facts in perspective, the authorities relied upon by plaintiffs to support their claim of primary liability against Citibank are not persuasive. The case of *Affiliated Ute Citizens* v. *United States,* 406 U.S. 128 (1972), for instance, is totally inapposite to the facts involved in the Private Placement. In *Affiliated Ute,* the Supreme Court's finding of 10b-5 liability of a bank was premised upon active encouragement of securities transactions by bank employees who, "in a distinct sense, were market makers, not only for their personal purchases . . . but for the other sales their activities produced." 406 U.S. at 152-153. The Supreme Court noted that the bank employees "did this by soliciting and accepting" orders for the stock purchases (*id.* at 152), and explicitly acknowledged that had the bank functioned merely as a transfer agent in connection with the securities sales, there would have been no duty of disclosure. *Id.* at 151-152. Likewise, Citibank's role as mere lender to Topper did not impose a duty upon it.*

Plaintiff's reliance on *SEC* v. *Texas Gulf Sulphur Co.,* 401 F.2d 833 (2d Cir. 1968), *cert. denied, sub nom. Coates* v. *SEC,* 394 U.S. 976 (1969), is even more puzzling. *Texas Gulf Sulphur* was concerned with the liability under Rule 10b-5 of various corporate insiders and their "tippees" with a duty to disclose information to the public when they traded or recommended trades on the basis of undisclosed inside information. Since Citibank neither traded nor recommended a trade (A28; Fdg D238), *Texas Gulf Sulphur* bears no relevance to the question of Citibank's liability.**

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* Plaintiffs' reliance on *Fischer* v. *New York Stock Exchange,* 408 F.Supp. 745, 751 (S.D.N.Y. 1976), *rev'd on other grounds sub nom. Lank* v. *New York Stock Exchange,* No. 76-7243 (2d. Cir. January 20, 1977), is hardly persuasive. The district court in *Fischer* based its descision not to grant the exchange's motion to dismiss the direct Section 10(b) claim on the exchange's own solicitation of the plaintiff. 408 F.Supp. at 745.

** Plaintiffs cite *Heit* v. *Weitzen,* 402 F.2d 909 (2d Cir. 1968), *cert. denied,* 395 U.S. 903 (1969), for the proposition that there need not be "contemporaneous trading" by an insider for liability to arise under Rule 10b-5 (Plaintiffs' Brief, p. 34). Plaintiffs fail to point out, however, that *Heit* involved subsequent trading induced by false

On the basis of the above facts and governing legal principles, Judge Knapp was eminently correct in his conclusion that Citibank owed no duty of disclosure to any plaintiff concerning Topper, and that, accordingly, any information given or withheld by Citibank relative to Topper could not result in Section 10(b) liability.

## II. Citibank Breached No Duty to Any Plaintiff.

### A. A Violation Requires a Finding of *Scienter—i.e.*, a Mental State Embracing an Intent to Deceive, Manipulate or Defraud.

As shown above, Citibank had no duty to plaintiffs in connection with the Topper Private Placement. However, even assuming *arguendo* that some kind of a duty to plaintiffs existed, the District Court was clearly correct in finding that Citibank did not breach any such duty. Each of

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financial statements previously prepared by defendants for the purpose of defrauding the government. *Mid-States Insurance Co.* v. *American Fidelity and Casualty Co.*, 234 F.2d 721 (9th Cir. 1956), and *Bowman & Bourdon, Inc.* v. *Rohr*, 296 F.Supp. 847 (D. Mass), *aff'd*, 417 F.2d 780 (1st Cir. 1969), are cited to the effect that if one speaks at all, he must make full and fair disclosure. (Plaintiffs' Brief, pp. 32-33) *Mid-States Insurance* involved charges of common law fraud against a defendant insurance company which, through deliberately false statements, aided its agent in the diversion of funds from another insurance company, which funds the agent turned over to the defendant insurance company. *Rohr* dealt with deliberate and concealed accounting changes in cost figures by a seller of securities, which changes produced a profit compared to the loss which would have resulted without such changes. Both cases, then, involved deceptive statements by sellers or actively involved insiders and are, accordingly, inapposite.

Finally plaintiffs' hornbook citations (Plaintiffs' Brief, pp. 33, 35) which deal with the duty arising from direct relationships between parties to a sale from which defendants derived benefit, are not persuasive as to Citibank, which neither brought nor sold nor had any relationship with any plaintiff relative to its purchase of the Topper Notes. (See pp. 9, 10, 36 *supra*) And even if Citibank had had such a relationship, Judge Knapp expressly found that any benefit to Citibank was insignificant and short-lived because Citibank made new loans to Topper in a continuing course of business. (A27-A29; Fdgs D407-D408)

**plaintiffs' claims is predicated upon a showing of *scienter*, whether the claim be that of direct liability under Section 10(b), aiding and abetting a violation of Section 17(a),* or being a controlling person under either Act** Plaintiffs have failed to prove *scienter* in this case, as the findings of the District Court amply demonstrate.**

**As plaintiffs concede, the requirement of *scienter*, that is, a "mental state embracing intent to deceive, manipulate**

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* Plaintiffs accuse Citibank of aiding and abetting a violation of Section 17(a) of the Securities Act.

The facts herein show none of the requisites of aiding and abetting:

> "Secondary liability under the federal securities laws may be imposed if a person has *actual knowledge* of another's improper scheme plus an *intent* to further that scheme (*i.e.* scienter), and he has given *substantial assistance* to the primary wrongdoer." *Rosen* v. *Dick*, CCH Fed. Sec. L. Rep. ¶ 94,786 at 96,604 [1974-1975 T.B.] (S.D.N.Y. 1974); (emphasis added)

Accord, *H. L. Federman & Co.* v. *Greenberg*, 405 F.Supp. 1332 (S.D.N.Y. 1975); *Rochez Bros.* v. *Rhoades*, 390 F.Supp. 470, 473 n.3 (W.D. Pa. 1974) *aff'd.* 491 F.2d 402 (3d Cir. 1975). See also Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification and Contribution*, 120 U. Pa. L. Rev. 597, 646 (1972). The record is eminently clear that Citibank had neither any actual knowledge of any improper scheme (A28), nor any intent to further such scheme (see pp. 41, 42, *infra*) and that Citibank gave no substantial assistance thereto. (See page 9, 10, *supra*)

Plaintiffs' claim that Section 17(a) requires no *scienter* is incorrect:

> ". . . So far as *scienter* might be concerned, the words of § 17(a) and 10b-5 are indistinguishable. And § 17(a) and 10b-5 are similarly affected by any implication arguments from the other sections. If anything, the implication argument is a little stronger in § 17(a) since it is part of the same Act that created §§ 11 and 12(2) and, like them, § 17(a) applies only against persons on the selling side." 2 A. Bromberg, *Securities Law: Fraud-SEC Rule 10b-5* § 8.4(330) (1975).

Accord, *Vacca* v. *Intra Management Corp.*, 415 F. Supp. 248, 250 (E.D.Pa. 1976); *Weber* v. *C.M.P. Corp.*, 242 F. Supp. 321, 322-325 (S.D.N.Y. 1965); *Gould* v. *Tricon, Inc.*, 272 F. Supp. 385 (S.D.N.Y. 1967); *Thompson* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 401 F. Supp. 111, 114 (W.D. Okla. 1975).

** See Point IV, *infra*.

or defraud" is now, once and for all, firmly established. *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 193, 194, n. 12 cont. (1976). Negligent conduct is insufficient. *Id.* at 214.*

The Supreme Court in *Hochfelder* clearly and explicitly recognized that a finding that a defendant acted in "good faith" precludes a finding of *scienter*:

> "There is no indication that Congress intended anyone to be made liable for such practices unless he *acted other than in good faith. The catchall provision of § 10(b) should be interpreted no more broadly.*" 425 U.S. at 206 (emphasis added).

Following *Hochfelder*, this Court, in *Franklin Savings Bank* v. *Levy*, No. 76-292 (2d Cir. March 9, 1977), recently reversed a finding of liability under Section 10(b), stating as follows:

> "It is apparent from a full reading of the opinion that the court never found that Goldman, Sachs possessed an intent to deceive, manipulate or defraud. Appellee does not argue that there was any such express finding but rather that the scienter required by *Ernst & Ernst* can be inferred from the facts found by the court. We do not believe that this is appropriate here, particularly since the trial court refused to admit testimony which had a decided bearing on the issue of the good faith *vel non* of Goldman, Sachs." *Id.* at 2243 (footnote omitted); *accord, University Hill Foundation* v. *Goldman, Sachs & Co.*, 422 F. Supp. 879 (S.D.N.Y. 1976).

Plaintiffs here similarly attempt to argue that *scienter* may be inferred from the facts found by the District Court. (Plaintiffs' Brief 19-25) In the present case, not only is such a back-door argument unsupported by the actual findings of the Court, it is indeed specifically contradicted by the District Court's finding of Waldman's good faith.

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* Plaintiffs expressly disclaim reliance upon theories either of "negligence" or "reckless disregard." (Plaintiffs' Brief, p. 17)

The District Court expressly found that Waldman (and, *a fortiori,* Citibank) acted in good faith in his conversation with Thompson upon which plaintiffs' claims principally rest. In asserting that good faith is irrelevent (Plaintiffs' Brief at 39-40), plaintiffs are thus quite emphatically wrong; it is, to the contrary, dispositive of this case.*

### B. Citibank Did Not Willfully Misrepresent or Withhold Material Facts.

The first basic flaw in plaintiffs' attempts to establish the requisite *scienter* on the part of Citibank is the total absence of evidence that Citibank knew what information any plaintiff had or did not have regarding Topper or, consequently, whether Topper or Orenstein was perpetrating a fraud upon plaintiffs. (Fdgs D38-D39; A28) This being the case, plaintiffs are forced to assume that Citibank must have known that a fraud upon plaintiffs would be necessary to sell the Topper Notes. As the District Court found, this suggestion is without foundation.**

There simply is no reason why Waldman should have felt constrained to do more than answer the questions put to him by Thompson.

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* Having failed to show the irrelevence of the District Court's "good faith" finding, plaintiffs attempt at length to prove that such finding was clearly erroneous. (Plaintiffs' Brief, pp. 43-53) Their contention is in large part that the oral testimony of Citibank's witnesses, including its expert, must be disregarded because of documentary evidence. This assertion fails for the simple reason that the relevant documents are consistent with and not contrary to such oral testimony, which was based in large part upon such documents. More specifically, the evidence established that Citibank's view of Topper was entirely justified (Fdgs D42-D59), and that Citibank's actions with respect to Topper's accounts receivable and overadvances were normal and prudent. (See pp. 17, 47, fn. *infra.*) The cases and secondary authorities cited by plaintiffs (Plantiffs' Brief, pp. 43-44), to the extent they are not inconsistent with the clear mandate of Rule 52(a) FRCP, are simply inapposite to circumstances where, as here, the testimony on behalf of Citibank was not only supported by documents but also consistent with undisputed expert testimony.

** "Neither the Bank nor any of its officers or employees either knew or had reason to know of any misrepresentation that Topper may have made to the Fund or to any other plaintiff." (A28)

The District Court's opinion described the Thompson-Waldman telephone conversation essentially as follows:

> "In essence, Waldman told Thompson that—from his point of view as a secured lender—Topper's was a wholly satisfactory account and that he neither knew of or nor foresaw any problem. In response to Thompson's request for investment advice, Waldman said he was in no position to give any.* (A26)

Based on these facts, the District Court found also that "Waldman acted in good faith in his conversation with Thompson" and "gave honest answers" to Thompson's questions. (A27; Fdg D235)

When questioned by Thompson about Topper, moreover, Waldman responded routinely and honestly. Thompson's memo quite simply records the only discussion of "problems" as follows:

> "The relationship between FNCB and Topper has been good and there are no problems at the moment nor does Mr. Waldman anticipate any." (A3532)

Given Topper's "turbulent history" (A3559) and inherently speculative financial condition as a typical toy manufacturer (Fdg D42), and the "marginal type of credit" normally associated with any factoring account (A3815; Fdg D234), Topper's relationship with Citibank in 1971 was not such that Thompson's casual, blanket inquiry into "problems" in that relationship should have brought forth a different response from Waldman than it did. See *Grimes, Hooper & Messer, Inc.* v. *Pierce,* CCH Fed. Sec. L.

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*"At trial the plaintiff—through testimony of Thompson and cross-examination of Waldman—attempted to create the impression that this conversation was both lengthy and involved. We have concluded that nothing of any consequence was said in the course of the conversation which is not reflected in plaintiffs' Exhibit 1397 [sic: 1379], the contemporaneous report that Thompson made to his superior, Molé." [Court's footnote]

Rep. [1975-1976 T.B.] ¶ 95,341 at 98,693 (C.D. Cal. 1973), *aff'd*, 519 F.2d 1089 (9th Cir. 1975).*

No facts have been established which justify plaintiffs' bald assertion that Waldman willfully failed to reply correctly to Thompson's inquiry on Topper. Plaintiffs claimed below that Citibank had knowledge of various *agreements* between Topper and its customers relating to rights of redating, warehousing, and returns and exchanges, which arrangements caused an overstatement of Topper's sales, and that Citibank's failure to disclose these agreements to plaintiffs was somehow actionable. (Complaint, ¶¶ 30-31, 54, 60, A20i-A20j, A20q, A20s) Having failed to discover any evidence whatsoever that Citibank knew of such arrangements, plaintiffs abandoned such claims and asserted, instead, that Citibank's knowledge of Topper's previous returns and concessions should have been passed on by Citibank to plaintiffs. (A452) Failing on this approach also, plaintiffs abandoned it (A30, n. 10) and now contend that Citibank should have disclosed a whole panoply of events which allegedly occurred in the summer of 1971.

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* Plaintiffs' attempts (Plaintiffs' Brief, pp. 27-29) to concoct a "fraudulent course of business" on the part of Citibank, aside from the content of the Waldman-Thompson phone call, must fail. First, plaintiffs are incorrect when they state that Citibank, either historically or in 1971, required Topper to raise outside capital or controlled Topper's financial policies, thereby setting in motion Topper's fraud. Equally important, plaintiffs' assertion is deficient for their inability to show the element of *scienter* which the very cases relied upon by plaintiffs require. *Buttrey* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135 (7th Cir.), *cert. denied*, 396 U.S. 838 (1969), for example, is not helpful. Involving actions which, if true, constituted an "almost callous disregard" for a New York Stock Exchange rule designed to protect brokerage house customers (410 F.2d at 141), *Buttrey* merely denied defendant's motion for summary judgment and held that the defendant broker-dealer might be liable under Rule 10b-5 if it had knowledge of another's scheme to defraud and enabled such person to "engage in large-scale speculations with its [the broker-dealer's] customers' funds through its [the broker-dealer's] office" and benefited from such "course of business which operated as a fraud." *Id.* at 144. Both of the other cases cited, *SEC* v. *R. J. Allen & Associates, Inc.*, 386 F. Supp. 866 (S.D. Fla. 1974) and *Reube* v. *Pharmacodynamics, Inc.*, 348 F. Supp. 900 (E.D. Pa. 1972), were also based upon either a showing of knowledge of fraudulent activity or actual, knowing participation therein, neither of which is present here.

The record is not in dispute that from the standpoint of the Citibank personnel handling the Topper account in 1971, Topper's returns and other concessions had been moderate, within expectations and a matter of little concern. (Fdgs D95-D96) Citibank and the other Lending Banks, who stood to lose most immediately from any such situation, would certainly have acted differently than they did, including advancing new funds to Topper, if they felt their collateral was in jeopardy.

Plaintiffs also claim that Citibank failed to advise plaintiffs of Topper's "financial condition" at the time of the Private Placement, specifically including the "increase" in Topper's past-due and ineligible accounts receivable in July and August, a slowdown in collections at that time and the overadvances extended to Topper by the Lending Banks.

No one at Citibank, of course, made any statement to plaintiffs concerning Topper's past-dues, collections or overadvances. Nor was Citibank's view of Topper, as a fully secured bank, such that an inference must be drawn that it was willfully withholding facts concerning Topper's financial condition. To the contrary, Citibank's view of Topper was fully justified on the basis of the information then available to it. (Fdgs D42-D59) Plaintiffs' attempts to paint, with the aid of 20-20 hindsight, a bleak picture of Topper as seen by Citibank will simply not bear up under analysis.

As earlier discussed, the Topper situation in July and August, 1971, with respect to past-due receivables and collections was not a matter of great concern to Citibank, but rather was consistent with Topper's past history and seasonal and monthly variations in business.* Moreover, Orenstein's assurances regarding the receivables made Citibank's satisfaction quite reasonable.

In short, Citibank's acceptance of Topper's assurances respecting its 1971 season was not suspicious. Citibank had no undue concern about Topper, nor was there any basis for

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* See pp. 10-15, *supra.*

such concern. (Fdgs D46, D59) When the May receivables were not all paid in May, Topper was nonetheless ahead of projection, and there was little reason for concern. Later, when the Sesame Street line came into production, and Topper was breaking records for its first six-months, the temporary lag in collections, at a traditionally slow time of year, was not a reason for alarm. (A3194; D49) The Lending Banks were more than adequately collateralized. In fact, the Lending Banks' collateral position appeared to be very strong during the Summer of 1971. In August, for instance, the excess of collateral over loans was approximately \$29 million (Fdg D47; A3792), while the over-advance situation of Topper was quite normal. (Fdgs D15-D16; A3793-A3799)

The Private Placement itself, together with the Ford Motor Credit loan, about both of which Topper advised Citibank during June, and the 1971 Topper public offering and its recent listing on the American Stock Exchange, were all further indications to Citibank that Topper was in good condition. (Fdg D47)

Citibank's other actions during the Summer of 1971 were totally consistent with its optimistic view of its Topper account. First, the evidence is uncontradicted that Waldman was "not happy" with the fact that the Ford Motor Credit loan cut into the Lending Banks' loan to Topper. (Fdg D34) Similarly, Citibank terminated the \$1 million participation of one of the Lending Banks, thereby increasing its own share, because the income from the Lending Banks' loan to Topper would be insufficient after the Ford Motor Credit agreement took effect. (Fdg D14) In addition, Citibank continued to make advances to Topper until in December 1971, when Topper's 1971 losses were announced (A29; Fdgs D407-D408). It is simply impossible to reconcile these actions with plaintiffs' portrayal of Citibank as a lender anxious to sell its debt from Topper to another.

Finally, the evidence is undisputed that Ford Motor Credit, unlike Thompson, itself reviewed the Topper files of Citibank, that Citibank supplied to Ford Motor Credit any

and all information on Topper requested (Fdg D375) and that Ford Motor Credit, with this and additional information supplied by Topper itself, was fully apprised of the status of Topper's receivables, collections and overadvances when it invested $7 million in Topper just 11 days prior to the Private Placement.* (Fdgs D389-D392)

Plaintiffs have simply failed to show as clearly erroneous the District Court's conclusion that there was no "intent to deceive, manipulate or defraud" behind any of Citibank's actions during the Summer of 1971. The District Court's finding that Waldman acted in good faith in his five minute conversation with Thompson, far from being "clearly erroneous," is the only conclusion consistent with the evidence.**

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* With Citibank's cooperation and assistance, Ford Motor Credit made an exhaustive study of Topper before and after committing to loan it $7 million in the Summer of 1971. (Fdgs D347-D389) Prior to the closing of the Ford Motor Credit loan on September 17, 1971, Ford Motor Credit knew that Topper's past-dues were ineligible for advances and totalled $8.2 million, that goods sold and held in Topper's warehouse facilities were ineligible for advances and totalled $4.3 million, and that less than 50% of Topper's gross receivables of $35,450,000 were eligible for advances. (A2149, A3853; Fdgs D390-D392)

** Citibank is not estopped from asserting a "good faith" defense. The District Court expressly found that Thompson called Jeffers to get specifically to Waldman, whom he knew to be in charge of the Topper account. (A26, n.5) This finding is not "clearly erroneous", despite plaintiffs' best efforts to portray it as such. It is established that Thompson had learned Waldman's name from Topper and knew he was to get information from him. (Fdg D163) In such circumstances, it would be unlikely and incredible that Thompson would not seek out Waldman by name, and the District Court was therefore quite justified in rejecting the contrary testimony. Plaintiffs' "estoppel" argument is essentially an indirect attempt to replace *scienter* with a lesser standard of culpability. Moreover, even if Thompson had asked to speak to Siegel instead of Waldman, it is undisputed that Siegel too would have given Topper a satisfactory credit report. (Plaintiffs' Brief, p. 40; A1291) Finally, even assuming *arguendo* that the Pension Fund did not ask to speak to Waldman, there is nonetheless no evidence that Waldman was chosen because he would respond to the Pension Fund's questions any differently than someone else would have.

Plaintiffs argue (Plaintiff's Brief, pp. 40-41) that adherence to routine practices may not always fulfill a duty. However, although adherence to an imperfect routine may subject a party to liability under a negligence standard, in the context of a violation requiring an intent to deceive adherence to normal practices does tend to negate *scienter.* One point particularly relied upon by the Fifth Circuit in *Woodward* v. *Metro Bank,* 522 F.2d 84 (5th Cir. 1975), is that the defendant bank's relations with the issuer were not unusual but were normal procedure. The court stated:

> "[t]he scienter requirement scales upward when activity is more remote; therefore, the assistance rendered should be both substantial and knowing. A remote party must not only be aware of his role; but he should also know when and to what degree he is furthering the fraud."
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> "If the evidence shows no more than transactions constituting the daily grist of the mill, we would be loathe to find 10b-5 liability without clear proof of intent to violate the securities laws. Conversely, if the method or transaction is atypical or lacks business justification, it may be possible to infer the knowledge necessary for aiding and abetting liability. In any case, the assistance must be substantial before liability can be imposed under 10b-5. See *Landy* v. *Federal Deposit Ins. Corp., supra,* 486 F.2d at 163; A. Bromberg, *Securities Law: Fraud-SEC Rule 10b-5* § 8.5 (530) (1974). Substantiality is a function of all circumstances." 522 F.2d at 95, 97. (footnote omitted)*

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* Waldman, Lusk and Siegel, all the employees involved in managing the Topper account in Citibank's factoring division, testified at trial. (A1162-A1163, A1276, A1352-A1353) In addition, Herbert R. Silverman testified as an expert witness as to Citibank's handling of the Topper account. Silverman, who was personally familiar with every aspect of commercial financing, reviewed in depth Citibank's files relating to the Topper account and testified that it was a good, well-managed account and that Citibank in handling the Topper account observed proper, prudent and very professional methods, all within the guidelines of proper, secured financing. (A1433-A1434; Fdg D24) His testimony was accepted in full by the District Court. (A47) See Rule 52 FRCP.

The lack of merit in plaintiffs' case can perhaps be summed up best by a quote from a recent Rule 10b-5 case involving a bank defendant accused of aiding and abetting an investor's violation of Rule 10b-5. Dismissing the Rule 10b-5 claim, based upon the fact that the bank, when queried in a credit check of the investor, failed to disclose certain information concerning him, the court stated as follows:

> "There is no evidence that plaintiff sought out Steinmann for information concerning Pierce under circumstances which would lead one to believe that plainttiff . . . was depending upon Steinmann's information for its decision. Steinmann's statements to plaintiff's officers concerning Pierce appear to have been made as an accommodation to plaintiff and seem only to be a good faith effort on the part of Steinmann to tell what he knew of Pierce. . . . It would place a great obstacle in the commercial world to hold a bank liable in damages because its officer used one adjective too many in dispensing honestly given data concerning one of its customers to an inquirer who made his inquiry under the informal circumstances testified to here. Moreover, I see no duty upon the manager of the bank in these circumstances to tell every small unflattering bit of information he knew or suspected concerning Pierce. . . ." *Grimes, Hooper & Messer, Inc.* v. *Pierce*, CCH Fed. Sec. L. Rep. [1975-1976 T.B.] ¶ 95,341 at 98,693 (C.D. Cal. 1973), *aff'd*, 519 F.2d 1089 (9th Cir. 1975).

In summary, plaintiffs have failed to cast doubt upon the District Court's findings which negate *scienter*, much less have they showed that such findings were clearly erroneous.

## III. There Was No Justifiable Reliance Upon Citibank.

The Pension Fund's investment in Topper was not made on the open market but was the result of personal

negotiation and investigation. In this context, the element of reliance is of crucial and very practical import, and cannot be dispensed with as may sometimes be possible in the case of impersonal, open market purchases. *Titan Group, Inc.* v. *Faggen,* 513 F.2d 234 (2d Cir. 1975), *cert. denied,* 423 U.S. 840 (1975); *see Lorber* v. *Beebe,* 407 F. Supp. 279 (S.D.N.Y. 1975). The Pension Fund asserts that its decision to invest in Topper depended greatly upon what Waldman said to Thompson. The facts show this was not so. Moreover, none of the other plaintiffs can show even a semblance of reliance upon Citibank.

Not only had Thompson satisfied himself as to Topper, but he had even decided to recommend participation in the Private Placement before August 27, when he talked with Waldman. As early as August 5, for instance, he told his superior that he would "like to do this [Topper] deal" if his superior agreed. (Fdg D167) In mid-August, moreover, Thompson advised another U.S. Steel officer that he wanted to do the Topper investment (Fdg D219) and prepared a memorandum in which he recommended it (A3528-A3531). Clearly Thompson's decision did not depend upon Waldman.

Given the Pension Fund's knowledge of Topper, the toy industry and Topper's history, it is simply incredible that Thompson could reasonably interpret the general remarks of Waldman, who Thompson knew was lending on a totally secured basis at a substantially higher interest rate than contemplated for the Private Placement, as a statement that there were no problems in Topper from an investment standpoint.* As in *Ferland* v. *Orange Groves of Florida, Inc.,* 377 F. Supp. 690, 707 (M.D. Fla. 1974):

> "[I]t is incumbent upon the complainant to demonstrate that the alleged misrepresentations were such as would have been relied on by a reasonable investor in

* This is especially so in light of Waldman's express refusal to state whether he thought Topper was a good investment. (A3532)

the exercise of due care under the facts existing at the time of the representations. Clement A. Evans & Co. v. McAlpine, 434 F.2d 100 (5th Cir. 1970), cert. denied 402 U.S. 988. . . . Given the speculative nature of the investment, as well as the nature of the alleged misrepresentations, the Court concludes that a reasonable investor, in the exercise of due care, would not have relied on the misrepresentations in making his decision to invest."*

Experienced securities analysts on the staff of the Pension Fund engaged in lengthy investigations into the affairs of Topper, including numerous conferences and conversations with representatives of Topper and Hayden Stone and the review of the several documents made available by these parties. It was on the basis of these conferences and documents that the Pension Fund based its decision to invest in Topper, and the Pension Fund's five-minute phone call with Citibank played no meaningful part in such decision.

This conclusion is particularly persuasive with respect to the exact aspects of Topper which plaintiffs assert Citibank should have disclosed—Topper's return policies and its financial condition in the Summer of 1971.

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* In *McLean* v. *Alexander,* 420 F.Supp. 1057 (D.Del. 1976), relied upon by plaintiffs, the court stated as follows:

> "[T]he duty of due care mandates that the plaintiff assess the information as would a person similarly possessed of his degree of business expertise.
>
> * * *
>
> "Sophisticated investors who possess either special expertise or the resources available to draw upon expertise, may be deemed to have knowledge of certain investments and their attendant risks, whether in fact they do or not and irrespective of whether material information was actually disclosed." *Id.* at 1078.

Thus, Judge Knapp attributed to Thompson, who "was running a $3 billion investment outfit", "some sophistication" and knowledge of how banks' factoring companies work. (A1585-A1586, A1599)

As to the subject of returns, the record is replete with the numerous inquiries made of Topper and Hayden Stone by Thompson and others at the Pension Fund. (See, e.g., Fdgs D153-D158) Thompson admitted at trial that he was so satisfied with repeated assurances from Topper representatives that Topper took "a hard line" on returns and had no guaranteed or consignment sales arrangements that he felt no need even to raise this subject when he talked to customers of Topper or to Waldman. (A605-A606, A631-A632) If reliance was placed upon anyone in this regard it certainly was not Citibank.

As to the question of Topper's financial condition in the Summer of 1971, the conclusion is the same. When he started his investigation into Topper in August 1971, Thompson was well aware of Topper's turbulent history. (Fdg D121) He had, in fact, brushed aside a potential investment in Topper just a year earlier as a "waste of time." (Fdg D122) Even at the time he formally recommended the Private Placement, Thompson looked upon it as an "interesting, though admittedly offbeat", investment for the Pension Fund, but justified "in view of the high expected payoff." (Fdg D247)*

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* Even when a duty to disclose is established, liability under Section 10(b) results only when the information misrepresented or withheld is material. *See SEC* v. *Texas Gulf Sulphur, supra* at 848-849; *see* generally Note, *Rule 10b-5: Elements of a Private Right of Action*, 43 N.Y.U.L. Rev. 541, 554 (1968). *See also TSC Industries* v. *Northway, Inc.*, 426 U.S. 438 (1976).

As stated by this Court, the duty to disclose

> ". . . arises only in 'those situations which are essentially extraordinary in nature and which are reasonably certain to have a substantial effect on the market price of the security if . . . disclosed.'" *SEC* v. *Texas Gulf Sulphur Co., supra,* 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied sub nom. Coates* v. *SEC*, 394 U.S. 976 (1969).

In this case, any information known by Citibank and allegedly "withheld" from plaintiffs was not material to their investment

Under these circumstances, given plaintiffs' knowledge of Topper and its history, the assertion that Waldman's negative answers to Thompson's questions whether there were or Waldman anticipated any current problems with the Topper account were relied upon by such an experienced securities analyst as a representation of Topper's financial condition from a potential subordinated investor's point of view is simply not credible. Particularly apropos here is the recent case *Marx & Co., Inc.* v. *Diners Club*, ______ F. 2d ____, CCH Fed. Sec. L. Rep. ¶ 95,892 (2d Cir. February 25, 1977), in which this Court noted that

> "it is certainly difficult to believe that plaintiffs, sophisticated investment bankers and businessmen, would have governed their conduct in reliance on such imprecise representations. . . . " *Id.* at 91, 301.

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decision. For instance, as noted above, Ford Motor Credit knew all this information when it invested $7 million in Topper eleven days before the Private Placement.

With respect to Topper's financial fluctuations, such as Topper's pre-tax net loss for July, 1971, and its effect on Topper's net earnings for the first seven months of 1971, it has been stated that "[a] one-month sharp decline in earnings might not be [the kind of 'special fact' which an insider has the duty to disclose], but a dramatic decline over a year most certainly would appear to fit any definition." Fleischer, *Securities Trading and Corporate Information Practices: the Implications of the Texas Gulf Sulphur Proceeding*, 51 Va. L. Rev. 1271, 1290 (1965) (footnote omitted). Certainly in the case of Topper, with its erratic, loss-filled history, a one-month drop in earnings would be immaterial to an investor, especially when the earnings through July 1971 compared favorably with the earnings through July 1970.

It is also noteworthy that the Pension Fund made no negative comments or inquiries when it received Topper's September 30, 1971 financial statements, which reflected substantially higher unpaid accounts receivable in relation to year-to-date sales than did the July 31, 1971 financial statements. (A2662, A2682) After Ford Motor Credit received and analyzed Topper's July 31, 1971 financial statements, it noted, among other things, that Topper had had steady earnings progress, and that Topper constituted less of a financial risk than it had when Ford Motor Credit had first committed to make its loan to Topper in July 1971. (A3856)

Even if Thompson relied on Waldman's negative answers, his reliance was not reasonable. (*See* A634) *Ferland* v. *Orange Groves of Florida, Inc.*, 377 F. Supp. 690, 707 (M.D. Fla. 1974); *see also Hafner* v. *Forest Laboratories, Inc.*, 345 F.2d 167 (2d Cir. 1965); 2 A. Bromberg, *Securities Law: Fraud-SEC Rule 10b-5*, § 8.4(652), at 204.247 (1975):

> "[t]here is widespread agreement among the courts that constructive knowledge of truth or omitted information will bar plaintiff from 10b-5 recovery."

As stated in *Shappirio* v. *Goldberg*, 192 U.S. 232, 241-242 (1904):

> "When the means of knowledge are open and at hand as furnished to the purchaser or his agent and no effort is made to prevent the party from using them, . . . he will not be heard to say that he has been deceived to his injury by the misrepresentations. . . ."

Judge Conner's statements in the recent case of *Caan* v. *Kane-Miller Corp.*, CCH Fed. Sec. L. Rep. [1975-1976 T.B.] ¶95,446 (S.D.N.Y. February 5, 1976), a merger case under Rule 10b-5, are very apropos:

> "This Court will not extend the obligations imposed by Rule 10b-5 to include a duty to communicate verbally every fact conceivably relevant to a corporate acquisition where the complainant was made aware of such facts through other means or should have become aware thereof through a reasonable inspection of documents or other material made available during the course of negotiations."
>
> * * *
>
> "Although 'sophisticated investors, like all others, are entitled to the truth', *Stier* v. *Smith*, 473 F.2d 1205, 1207 (5th Cir. 1973), the claimant's sophistication, expertise and business acumen, its access to information and opportunity to detect the alleged fraud are all

relevant considerations in determining the exercise of reasonable diligence."

* * *

"However, the securities laws are not to be used as an insurance policy for investors who choose voluntarily to disregard facts which would have been uncovered by any reasonable person in their position." (*Id.* at 99,242).*

**IV. The District Court Correctly Found That Citibank Was Not Liable As a Controlling Person.**

Plaintiffs incorrectly argue that Citibank should be held secondarily liable as a "controlling person" under Section 15 of the Securities Act of 1933, 15 U.S.C. § 77o

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* Weak as the Pension Fund's case is, that for the other plaintiffs is weaker still. They had no contact whatsoever with Citibank regarding the Topper Private Placement, and no one at Citibank said anything to any of them about Topper. Connecticut Mutual's securities analyst, Leonard Hieronymus, made an investigation of Topper regarding the Private Placement somewhat similar to that of the Pension Fund. (Fdgs D286-D326) Like Thompson, Hieronymus read the Private Placement Memorandum and the Examples of Company's Reporting, made an all-day visit to Topper, talked extensively to officials of Topper and Hayden Stone, contacted two of Topper's largest customers, was given full access to Topper's records and was free to check anything he wanted. (Fdgs D287-D304, D307-D310, D315-D316, D318-D319)

Hieronymus first prepared an Industrial Summary Sheet dated August 30, 1971 (A3574-A3585), which did not mention Citibank or Thompson's bank check. (Fdgs D312, D322) His colleagues reviewed it and in a meeting on September 2, 1971 decided to recommend participation in the Private Placement to the Executive Committee. (Fdgs D320-D322) It was not until after the September 2, 1971 meeting that they even knew about Thompson's bank check. (Fdg D324) Hieronymus later prepared a memorandum for the Executive Committee (A3586) which also did not mention Citibank or Thompson's bank check. The Executive Committee routinely approved the investment in Topper at a meeting on the morning of September 3, 1971. (Fdgs D322-D323)

There was no contact whatever between Citibank and the Dallas Bank regarding Topper. (Fdg D337) Prior to the Private Placement, the Dallas Bank did not know that the Pension Fund had contacted Citibank (Fdg D339), and did not rely on Citibank relative to its investment in Topper. (Fdg D341)

and Section 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78t(a). As the District Court concluded:

> "Even if Citibank were a controlling person, it would not be liable for its controllee's unsuspected frauds. *Gordon* v. *Burr* (2d Cir. 1974) 506 F.2d 1080; *Lanza* v. *Drexel & Co.* (2d Cir. 1973) 479 F.2d 1277, 1299. Furthermore, . . . the Bank was not in fact such a controlling person." (A31)

The District Court was correct, both as to the law and the facts, and plaintiffs' control arguments should be rejected.

**A. Citibank Did Not Control Topper**

While "controlling person" and "control" are not defined in the Securities Act or the Exchange Act, many courts have looked, at least in the first instance, to the Securities and Exchange Commission's definition of control in its regulations promulgated under those acts:

> "The term 'control' (including the terms 'controlling', 'controlled by' and 'under the common control with') means the possession, direct or indirect, of the power to direct or cause the *direction of the management and policies* of a person, whether through the ownership of voting securities, by contract, or otherwise." SEC Rule 405, 17 C.F.R. § 230.405(f) and SEC Rule 12b-2(f), C.F.R. § 240-12b-2(f) (emphasis added).

*See, e.g., Ayers* v. *Wolfinbarger,* 491 F.2d 8 (5th Cir. 1974); *Winter* v. *D.J. & M. Investment & Construction Corp.,* 185 F. Supp. 943, 947 (S.D. Cal. 1960). As stated by this Court in one recent case:

> ". . . this evidence could not . . . give him the necessary power over its management and policies to constitute him a 'controlling person'." *Aid Auto Stores* v. *Cannon,* 525 F.2d 468, 471 (2d Cir. 1975)

Judge Knapp found that Citibank did not have or exercise control over Topper's management or policies, directly or indirectly.

It is, moreover, necessary that the influence under consideration relate to the wrongful act for which liability is ultimately sought. *Lanza* v. *Drexel & Co.*, 479 F.2d 1277, 1299 (2d Cir. 1973); *Belhumeur* v. *Dawson*, 229 F. Supp. 78, 84 (D. Mont. 1964); *Kappus* v. *Western Hills Oils, Inc.*, 24 F.R.D. 123, 128 (E.D. Wis. 1959). Citibank had merely the negative powers typical of an agent for secured lenders in a financing situation such as Topper's: it could determine amounts to be loaned to Topper under the Financing Agreement. (Fdg D18) As the District Court found, Citibank "played no part in Topper's management other than to advise on what terms it was willing to continue its loans" (A29) and exercised no more "control" over the affairs of Topper than was normal in the commercial financing industry. (Fdgs D18-D19)*

Citibank did not participate in or control Topper's various business practices, which were formulated and carried out by Topper itself and before Citibank was aware of them. Citibank's only discussion regarding such practices was whether the Lending Banks would advance funds. Topper continued some sales practices even after Citibank declared receivables resulting therefrom ineligible. (Fdg D20) Nor did Citibank initiate or otherwise get involved with Topper's sales or marketing decisions; as one Topper officer put it, the banks did not presume to tell Topper how to run its business. (Fdgs D21-D22) Finally, Citibank did not control Topper's financings, either private or public (including the Private Placement), as to which Topper ordinarily advised Citibank after the fact. (Fdgs D29-D32, D36)**

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* The testimony by Mr. Silverman, Citibank's expert witness, was clear on this point (A1435-A1436) and was fully accepted by the District Court.

** Plaintiffs (Brief, p. 30, n. 19) purport to support their control arguments by excerpts from the Rose and Orenstein depositions, although the District Court specifically rejected proposed findings of fact based on the very same deposition extracts, "there being nothing in the evidence to suggest that either of them is worthy of belief." (¶ 15, A34) In any event, such depositions do not support plaintiffs' contentions.

Citibank's mere lending relationship to Topper, fully disclosed by Topper to all plaintiffs, will simply not support a claim of control. This conclusion is expressed in one case as follows:

> "In the present case, the facts indicate that C.M. Gay [president and chairman of the board of directors of Citizens National Bank], by reason of his influence over Citizens National Bank, had a measure of control over the ability of the Selling Corporations to borrow money from Citizens National Bank. To conclude from this, however, that C.M. Gay had the ability, in fact or in law, *to control the activities of the Selling Corporations in relation to the latter's own customers* is an unwarranted interpretation of the facts. The evidence does not support that conclusion. . . . For this reason neither C. M. Gay nor Citizens National Bank should be considered 'controlling persons' under 15 U.S.C. § 77o or § 78t. . . ." (emphasis added), *Ferland* v. *Orange Groves of Florida, Inc.*, 377 F. Supp. 690, 707 (M.D. Fla. 1974).

*See also Ayers* v. *Wolfinbarger*, *supra*, 491 F.2d at 15.

Plaintiffs cite cases indicating that "control", for present purposes, is a fact-oriented term (Plaintiffs' Brief, p. 29). Citibank agrees that control is a factual question, as to which the District Court made specific findings. These findings were not "clearly erroneous" in the light of the cited cases or otherwise. No case relied upon by plaintiffs even remotely approaches the factual situation here.*

* Plaintiffs misleadingly imply that the District Court found that Citibank had "[c]ontrol over [Topper's] financial policies." (Plaintiffs' Brief, p. 30) The District Court did not so find, nor do plaintiffs offer any support for this stark remark. Further, plaintiffs' citations to general discussions of the influence of banks and creditors—all but one in a non-securities law context—are at best irrelevant and at worst misleading. The only case cited which was arguably in a "securities" setting is *Chicago Corp.*, 28 S.E.C. 463 (1948), which involved none of the sections at issue here, but rather Section 2(a)(9) of the Investment Company Act of 1940, which creates a rebuttable presumption of control if a company has more than 25% of the voting securities of another. The case is hardly on point.

**B. Citibank acted in good faith**

To be held secondarily liable as a "controlling person" under Section 20(a) of the Securities Exchange Act of 1934, a defendant must, in addition to possessing the requisite power over management and policies of the controlled person, have culpably participated in the controlled person's fraud and acted other than in good faith. Plaintiffs must carry their burden of showing some degree of culpable participation and defendant must fail to carry its burden of showing good faith in order that liability be established. As this Court has stated with respect to Section 20(a):

> "The intent of Congress in adding this section . . . was obviously to impose liability only on those . . . who are in some meaningful sense culpable participants in the fraud perpetrated by controlled persons." *Gordon* v. *Burr,* 506 F.2d 1080, 1085 (2d Cir. 1974), citing *Lanza* v. *Drexel & Co.,* 479 F.2d 1277, 1299 (2d Cir. 1973) (en banc).*

Plaintiffs do not even begin to suggest "culpability."** This issue is, as a factual matter, foreclosed by Judge Knapp's finding that Waldman acted honestly and in "good faith." (A27; Fdg D235)

Plaintiffs argue that the District Court erred in finding that "[n]either the Bank or any of its officers or employees either knew or had reason to know of any misrepresentation that Topper may have made to the Fund or any other

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* *Gordon* involved § 20(a) of the Securities Exchange Act of 1934. Section 15 of the Securities Act of 1933 contains essentially similar provisions, and the arguments of plaintiffs as to both sections fail for the same reasons.

** Plaintiffs' reference to *Woodward* v. *Metro Bank,* 522 F.2d 84 (5th Cir. 1975), is puzzling, since that case did ***not*** involve "control" allegations. In any event, however, reliance on that case is misplaced. The defendant bank there was held not liable as an aider and abettor even though it was held to have had notice of the precarious financial condition of a borrower for whom plaintiff had become an accommodation maker on a note to the bank and even though the bank had asked the borrower to find an accommodation maker.

plaintiff." (A28) Plaintiffs' objection to this finding appears to be based solely on their assertion that since others were considering advancing money which Citibank did not advance, Citibank must be "presumed" to know that there were misrepresentations. This assertion, of course, is unsupported, both factually and legally. It ignores the simple facts that Citibank did not know what others were saying to plaintiffs, had confidence in Topper and its management and advanced large sums to Topper both before and after the Private Placement, although under its demand loan relationship with Topper it could have stopped advances whenever it desired. See pp. 5, 9, 11-12, 31, *supra.**

**V. Citibank is Not Liable to the Pension Fund for Breach of Common Law Duties Arising Out of the 1950 Custodian Agreement.**

The Pension Fund argues that Citibank, as a result of the telephone conversation between Waldman and Thompson, is liable to it for breach of common law duties arising out of the 1950 Custodian Agreement between it and Citibank. As the opinion of the District Court and the findings adopted therein clearly demonstrate, however, that telephone call did not constitute a request by the Pension Fund

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* The two "facts" claimed to show Citibank's knowledge of misrepresentations do not show anything. First, plaintiffs cite Siegel's "belief" that at some unknown time, possibly long after the Private Placement, he had seen the Topper public offering prospectus and had a general discussion about it with someone else at Citibank. Whatever the significance of this—and it cannot have much significance—the fact remains that neither Siegel nor anyone else at Citibank knew what information had been given to plaintiffs. (Fdg D38) Second, plaintiffs incorrectly assert, without furnishing any detail, that Thompson's questions to Waldman made clear that the Pension Fund was not "fully apprised of Topper's true financial state." To the contrary, nothing in such questions (even as articulated by plaintiffs) should have indicated to Citibank that Topper had made misrepresentations to the Pension Fund. Plaintiffs certainly suggest nothing which makes Judge Knapp's findings on this point clearly erroneous.

for investment advice within the purview of the 1950 Custodian Agreement nor did anyone at Citibank (including Messrs. Waldman or Jeffers) believe that Citibank was being asked to give investment advice pursuant to that Agreement. (A28; Fdgs D281-D283)*

The District Court's findings allow no basis whatever for the Pension Fund's claim of breach by Citibank of the Custodian Agreement. Whatever duty Citibank may have owed to the Pension Fund in matters falling within the Custodian Agreement is not germane to the Pension Fund's investment in Topper.

This principle is well demonstrated in cases concerning contracts between beneficiaries and trustees acting outside their capacity as such. It is well recognized that

> "[a]ll direct business dealings between persons in a fiduciary or confidential relation are governed by the doctrine [that a trustee has a duty to show good faith and fair play in direct dealings with a trust beneficiary] in so far as they effect that relationship or the property involved in it, *but not if they are concerned with property owned by either party which is unrelated to the trust or other similar fiduciary relationship.*" (emphasis added). G. Bogert, *The Law Of Trusts & Trustees* § 544, at 613-14 (2d ed. 1960).

See also V. A. Scott, *Law Of Trusts* § 504, at 3558 (3d ed. 1967). *Accord, Troyak* v. *Enos,* 204 F.2d 536, 542 (7th Cir. 1953); *Stone* v. *Stone*, 407 Ill. 66, 94 N.E.2d 855, 861 (1950); *First National Bank & Trust Co.* v. *Gold,* 217 Wis. 522, 259 N.W. 260 (1935); *Ehrich* v. *Brunschwiler,* 241 Ill. 592, 89 N.E. 799, 800 (1909) (". . . the relation . . . of trustee and cestui que trust . . . did not extend to all the affairs of their lives.") A trustee under fiduciary obligations to his trust beneficiary may deal with him outside the

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* See pp. 29-30 *supra.*

fiduciary relationship in other than a fiduciary manner, and such dealings are not governed by fiduciary rules of conduct.

Significantly, the Pension Fund does not challenge the findings that the inquiry made regarding the Private Placement was not a request for investment advice made within the terms of the 1950 Custodian Agreement, and that the Pension Fund did not view its Private Placement inquiry as such. Rather, the gist of the Pension Fund's present argument appears to be that occasional inquiries of Citibank by the Pension Fund for specific information on certain issuers of which Citibank had some knowledge because of a past or present credit arrangement constituted a course of conduct broadening the scope of "investment advice" within the terms of the 1950 Custodian Agreement. The Pension Fund urges that this course of conduct brings the Private Placement inquiry within the 1950 Custodian Agreement.

The Pension Fund's argument, however imaginative, is incorrect and flatly contradicted by the facts. In addition to providing for numerous duties of an administrative nature the Custodian Agreement merely provided for the rendering of "investment advice", which consisted of four meetings a year with senior Citibank economists. (Fdgs D272, D274-D275) The District Court thus held that the Private Placement inquiry was *not* a request for investment advice based on that Agreement or any other special relationship between the Pension Fund and Citibank. (A28; Fdg D281) Despite the Pension Fund's semantic ingenuity, there is no "ambiguity" to be resolved; rather, the Court's findings match perfectly the contractual provisions relied upon below by the Pension Fund. It is therefore unnecessary to consider the Pension Fund's arguments regarding a course of conduct.

Even were the "course of conduct" argument reached, however, the Pension Fund's claim would fail. The occasional earlier inquiries made by the Pension Fund

regarding issuers with whom Citibank had a past or present credit relationship were, like the Private Placement inquiry, mere credit checks or requests for specific information, not requests for investment recommendation. (Fdgs D276, D278-D279) Such requests of an outsider who had some particular knowledge of the issuer were the Pension Fund's standard practice with respect to proposed private placements. (Fdg D277) As with the Private Placement, the Pension Fund would have made such checks with whatever banks handled the issuer's loans (Fdg D237). Such inquiries were no more considered to be requests within the Custodian Agreement than was the Private Placement inquiry. (Fdg D276) Far from constituting a course of conduct such as the Pension Fund urges, these earlier occasions in fact harmonize exceedingly well with the District Court's finding that the Private Placement inquiry was not within the scope of the Custodian Agreement.

Thus, the Pension Fund errs when it argues support for its "interpretation" in the fact that Citibank's failure to note specifically on each of the earlier occasions that it did not deem such inquiry within the Custodian Agreement. Of course Citibank did not, since such credit check inquiries were obviously *not* within the Custodian Agreement and neither the Pension Fund nor Citibank so considered them.

For the above reasons, Citibank had no special duty of disclosure arising out of the Custodian Agreement with respect to the Pension Fund's credit check on Topper.

## CONCLUSION

The decision of the District Court should be affirmed in all respects.

Dated: New York, New York
March 23, 1977

Respectfully submitted,

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